Conforming Tax Avoidance and SEC Tax-Related Comment Letters

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ABSTRACT

This study explores whether SEC tax-related comment letters affects conforming tax avoidance. Conforming tax avoidance involves tax planning strategies that reduce firms' book and taxable incomes simultaneously. We find that after resolving tax-related comment letters, firms increase their use of conforming tax planning strategies. In contrast, firms decrease nonconforming tax avoidance activities (Kubick et al. 2016), where taxable income is reduced without reducing book income. Overall, there is no significant change in firms' total level of tax avoidance following the resolution of tax-related comment letters. This suggests that firms substitute the riskier nonconforming tax planning with conforming tax planning in response to increased regulatory scrutiny of tax disclosures. Additionally, managerial decisions to pursue conforming tax avoidance are found to be constrained by capital market pressure and debt contract covenants, while they are encouraged by executive equity incentives and managerial monitoring mechanisms. These findings collectively provide insights into how regulatory scrutiny on tax disclosures influences firms' trade-off between different tax planning strategies.

Keywords: SEC tax-related comment letters, regulatory scrutiny, conforming tax avoidance, nonconforming tax avoidance, tax planning strategy.

1. INTRODUCTION

Conforming tax avoidance, where firms engage in tax planning strategies that reduce both book and taxable incomes, has recently attracted increasing attention in the corporate tax avoidance literature (Badertscher, Katz, Rego and Wilson 2019; Kara, Mayberry and Rane 2023). Prior studies primarily focus on nonconforming tax avoidance, which involves lowering the taxable income reported to tax authorities without changing the book income reported in financial statements. Unlike nonconforming tax avoidance, conforming tax avoidance often carries less enforcement costs stemming from negotiation and settlement with tax authorities (Kara et al. 2023). This is because conforming tax avoidance does not result in book-tax differences, thus making it less detectable in tax audits. Furthermore, conforming tax strategies generally require no controversial interpretation of tax laws. Therefore, firms faced with higher enforcement risk may find book-tax conforming strategies more appealing.

Conforming tax avoidance is associated with its own costs. The reduction in tax liabilities is at the expense of reporting lower earnings (Badertscher et al. 2019; Kara et al. 2023). Firms with lower reported earnings may find it difficult to raise external financing from shareholders and debtholders. It could be challenging for managers to communicate that reporting lower earnings is for the benefits of generating cash tax savings. Moreover, managers' compensation can also be negatively affected if it is linked with reported earnings. Further, conforming tax strategies may involve delaying sales or accelerating expenses, which likely disrupt firms' operational decisions. Firms have conflicting incentives to increase earnings and also avoid taxes when deciding the extent to which they engage in conforming tax avoidance. In this study, we explore whether and how regulatory scrutiny, in the form of tax-related comment letters issued by the Securities and Exchange Commission (SEC), is associated with conforming tax avoidance.

We focus on SEC scrutiny of tax-related financial disclosures because it could potentially have both reporting and tax implications. To fulfil their oversight role, the SEC regularly reviews firms' financial statements and issues comment letters to enhance compliance with disclosure requirements and accounting standards. If the SEC comments identify issues with financial reporting, firms receiving comments may be induced to change their discretionary accounting or operation choices (Cunningham, Johnson, Johnson and Lisic 2020). Prior research has also documented a spillover effect of tax-related SEC comment letters in decreasing firms' nonconforming tax behaviour (Kubick, Lynch, Mayberry and Omer 2016).

Prior studies show that the Internal Revenue Service (IRS) uses financial information, including SEC comment letters, to help identify corporate tax avoidance (Bozanic, Hoopes, Thornock and Williams 2017; Fox and Wilson 2022). The tax-related SEC comments, which indicate ambiguities or deficiencies in corporate tax disclosures (Kubick et al. 2016), are likely to increase the probability of firms' tax positions being challenged and overturned in the future. When the enforcement costs associated with nonconforming tax avoidance increase, firms may have greater incentives switch to other, less costly, forms of tax avoidance, to generate a desired level of tax cash savings for the benefits of shareholders. Conforming tax avoidance, as it involves lower enforcement risk, is one way to respond to increased tax-related regulatory scrutiny. However, given the costs of conforming tax activities and the availability of other less risky tax strategies, it remains an empirical question as to whether firms engage in more conforming tax avoidance to compensate for the anticipated reduction in nonconforming tax avoidance following tax-related SEC comment letters.

We estimate conforming tax avoidance using the newly developed measure from Badertscher et al. (2019). Specifically, it is calculated as the residual from regressing the ratio of cash taxes paid to lagged assets on total book-tax differences and also tax-related controls. Following Kubick et al. (2016), a difference-in-differences model is employed to test the effects of tax-related comment letters on firms' tax planning strategies. The treatment firms are these that have received a tax-related comment letter and the control firms are those that have received a non-tax-related comment letter. We match the control to treatment firms using a propensity score matching design with exact matching on year and industry and nearest-neighbour matching on other covariates without replacement.

We find that conforming tax avoidance is significantly higher after the resolution of a tax-related comment letter. Similar to Kubick et al. (2016), we also find nonconforming tax avoidance is significantly lower following a tax-related comment letter. These results suggest that tax-related comment letters provide incentives for firms to switch from nonconforming tax activities and shift to the less costly conforming tax activities. To understand the change in overall tax avoidance, we employ a measure that reflects both conforming and nonconforming tax planning, and find statistically insignificant difference in total tax avoidance, suggesting that managers offset the anticipated decrease in nonconforming tax planning with a similar increase in conforming tax planning.

We also conduct several supplemental tests to support our primary results. By examining the two years preceding a tax-related comment letter, the results show that our difference-in-differences tests meet the parallel trend assumptions. We observe no change in conforming tax avoidance when repeating the difference-in-differences estimations on pre-event years, which provides comfort that the effect of tax-related comment letters is not attributable to past events or general time trends. In addition, we partition the main sample based on the extent to which firms reduce their nonconforming tax avoidance after resolving tax-related comment letters. Results indicate that the increase in conforming tax avoidance appears to be concentrated in firms experiencing a greater reduction in nonconforming tax avoidance.

To understand the mechanisms underlying managerial incentives to engage in conforming tax avoidance, we perform a number of cross-sectional tests examining four factors in particular: capital market pressure, loan contract covenants, executive equity incentives and investor / board monitoring mechanisms. As suggested by prior research (Badertscher et al. 2019), conforming tax avoidance is more appealing when firms are less concerned about the amount of income reported in financial statements. Dividing the sample into firms that are subject to higher versus lower market pressure, we show that the increased level of conforming tax avoidance following tax-related comment letters is only present in the sub-sample of firms facing lower pressure from the capital market. Considering pressure from the debt market, we find that firms that are not subject to earnings-related financial covenants are more willing to avoid taxes in a book-tax conforming manner after the resolution of a tax-related comment letter. In contrast, firms that are subject to those covenants tend to reduce their level of conforming tax avoidance in order to maintain a satisfactory level of reported earnings. Prior studies also suggest that there are more incentives for conforming tax avoidance when manager interests are better aligned with that of shareholder (Kara et al. 2023). Focusing on equity incentives, in particular, how CEO's wealth is linked to stock price volatility (i.e. vega) and stock price (i.e. delta), we observe that the significant effect of tax-related SEC scrutiny on conforming tax avoidance is only present for firms with higher vega and lower delta. Moreover, we find that well-monitored firms, in which there is better interest alignment between managers and shareholders, exhibit an increase in conforming tax avoidance in response to greater scrutiny of tax-related financial reporting but such increase cannot be found for firms without good monitoring mechanisms.

Further analyses focus on how managers reduce tax liabilities in a book-tax conforming manner. We test the influence of tax-related SEC comment letters on firms' accrual-based and real-activities-based earnings management. There is no evidence of a change in discretionary accruals after resolving a tax-related comment letter. However, there is finding that managers increase tax-motivated downward real earnings manipulation using their discretion to delay the timing of sales and report higher cost of goods sold.

The results of our study contribute to the literature investigating the consequences of tax-related SEC comment letters and their resolution (Kubick et al. 2016; Edwards, Klassen and Pinto 2019; Ehinger 2020). Kubick et al. (2016) find that tax-related SEC scrutiny has the spillover benefits of deterring nonconforming tax avoidance. We consider conforming tax avoidance and find that firms engage in more book-tax conforming tax planning strategies as a substitute for nonconforming strategies when there is increased tax-related SEC scrutiny. Accordingly, this study provides a more complete picture of how managers trade off the different ways to avoid taxes considering their relative costs and benefits. Firms with greater regulatory scrutiny do not simply reduce tax avoidance but instead alter their tax strategy. Therefore, merely focusing on nonconforming tax avoidance might underestimate the total level of tax avoidance, resulting in incorrect inferences for the extent and determinants of corporate tax avoidance. This informs that it is not enough for tax policies to only target book-tax differences and regulators need to contemplate the availability of conforming tax strategies if they want to deter tax avoidance.

Using this broad measure of conforming tax avoidance from Badertscher et al. (2019), we add to the emerging line of studies investigating the incentives for conforming tax planning (Kara et al. 2023; Eichfelder, Jacob, Kalbitz and Wentland 2024). While there are papers examining specific examples of tax strategies that simultaneously reduce book and taxable incomes (Penno and Simon 1986; Guenther 1994; Maydew 1997), the conditions under which managers are willing to report lower income have been largely understudied. Recent studies show that capital market pressure (Badertscher et al. 2019) and executive equity incentives (Kara et al. 2023) are associated with firms' conforming tax planning decisions. By examining the effects of SEC tax-related comment letters, we suggest that regulatory scrutiny of tax-related disclosures encourages conforming tax avoidance. We also provide evidence that debt covenants negatively affect conforming tax planning and good monitoring mechanisms provide managers with more comfort to avoid taxes in a book-tax conforming manner.

The effect of SEC scrutiny on conforming tax avoidance is important for tax authorities, corporate managers and investors. As tax authorities could potentially use the tax-related SEC comment letters to identify firms and issues to target in tax audits (Kubick et al. 2016), our results suggest that they focus more on detecting conforming tax strategies such as timing altercations of sales and production. We also inform executives and shareholders of a special situation where there appears to be increased risk of conforming tax avoidance. Despite the obvious benefits of cash tax savings, conforming tax avoidance can also impose significant costs as changing operation could result in impairment of investors' ability to forecast earnings and affect their evaluation of managers' overall performance (Kara et al. 2023).

2. LITERATURE REVIEW

2.1 Book-Tax Conforming Tax Avoidance

Tax avoidance is generally defined broadly as encompassing all transactions that results in a reduction in firms' explicit tax liabilities (Hanlon and Hertzman 2010). Corporate managers can reduce their firms' tax burden using a vast array of strategies, which could be broadly categorised into nonconforming and conforming tax avoidance in the tax literature (e.g., Badertscher et al. 2019; Kara et al. 2023; Eichfekder et al. 2024). Nonconforming tax avoidance occurs when a firm employs tax strategies that decrease income tax liabilities but do not affect the book income reported in their financial statements. In contrast, conforming tax avoidance refers to those tax strategies that reduce both book income publicly available to investors and taxable income reported to tax authorities in order to achieve a lower tax liability. Examples of conforming tax avoidance strategies include switching inventory cost flow assumption methods (Hunt, Moyer and Shevlin 1996; Badertscher et al. 2019), shifting expenses to current reporting periods and revenues to subsequent periods (Scholes, Wilson and Wolfson 1992; Maydew 1997; Klassen 1997), prepaying financing costs, expensing instead of capitalising a cost, entering into sale-and-leaseback transactions and some types of forward contracts (Kara et al. 2023).

Firms that avoid taxes in a book-tax conforming manner face a unique cost-benefit trade-off. On the one hand, as conforming tax avoidance reduces tax burden by reducing book income, firms must have lower reported income if they want more cash tax savings (Cloyd, Pratt and Stock 1996). Correspondingly, firms that would like to maintain higher reported income are

unlikely to have lower tax liabilities, unless they engage in nonconforming tax avoidance which decrease tax liabilities without decreasing book income. On the other hand, conforming tax avoidance comes with lower tax risk as it can be achieved through transactions that do not involve controversial interpretations of tax law (Mills 1998) and, thus, making it more difficult to be detected by the tax authorities. Unlike nonconforming tax avoidance that usually carries expected costs of negotiation and penalties stemming from possible tax audits (Hoopes, Msecall and Pittman 2012) and reputational concerns about potential risks of getting caught (Gallemore, Maydew and Thornock 2014), firms adopting the book-tax conforming tax planning strategies have lower enforcement and reputational costs.

Extant tax research focuses mainly on nonconforming tax avoidance because most commonly used measures of tax avoidance do not capture conforming tax avoidance. For example, the effective tax rate measures, i.e. GAAP ETR and cash ETR, are calculated using a firm's tax expense or cash taxes paid as numerator and pre-tax financial statement income as denominator (Rego 2003; Dyreng, Hanlon and Maydew 2008). Both of them reflect differences in book and taxable income, but do not allow for inferences about conforming tax strategies that change the numerator (tax burden) and the denominator (book income) in the same direction. In addition, the several book-tax difference measures are computed as the difference between pre-tax book income and estimated taxable income (Mills 1998; Weisbach 2002; Frank, Lynch and Rego 2009). The effects of book-tax conforming transactions would cancel out in these measures when book and taxable income are simultaneously reduced. All of these effective tax rate based and book-tax difference based measures can properly reflect nonconforming tax avoidance but ignore the existence of conforming tax avoidance (Badertscher et al. 2019).

Despite the absence of a generally accepted measure of conforming tax avoidance, there are prior studies examining specific transactions that affect book and taxable incomes similarly. In particular, managers balance the tax benefits and the financial reporting costs of inventory costing methods (Dopuch and Pincus 1988), equity compensation decisions (Matsunaga, Shevlin and Shores 1992) or major asset divestitures (Klassen 1997), and they are willing to reduce their firms' tax burden at the expense of reporting lower financial income in those circumstances where the tax benefits outweigh the financial reporting costs. Furthermore, in response to the U.S. corporate statutory tax rate change from 46 percent in 1986 to 34 percent in 1988, Scholes et al. (1992) document an intertemporal shifting of book income through gross margins and selling, general, and administrative expenses to maximise tax benefits. In addition,

Maydew (1997) analyses those firms with operating losses and their shifting of recurring versus non-recurring revenues and expenses in a book-tax conforming manner. As there was no well-established aggregate measure of conforming tax avoidance, previous research could only identify "tax-induced earnings management" (Guenther 1994; Maydew 1997) through changes in specific expenses and revenues.

Recently, Badertscher et al. (2019) develop a measure to capture the broader tax implications of conforming tax strategies. Their measure is estimated by regressing the ratio of cash taxes paid to total assets on book-tax differences and other tax-related firm attributes. Taxes paid to assets ratio reflects a firm's total explicit tax liability that captures both nonconforming and conforming tax avoidance. Book-tax difference is considered a measure of nonconforming tax avoidance. The unexplained variation (i.e. residual) in total tax avoidance when regressed on the proxy for nonconforming tax avoidance and other controls is therefore used as a measure of conforming tax avoidance. Badertscher et al. (2019) use this measure to show that private firms are more likely to engage in conforming tax planning than public firms, which confirms the implications from prior studies investigating the different tax incentives faced by public and private firms (Penno and Simon 1986; Cloyd et al. 1996; Mills and Newberry 2001). They further examine cross-sectional variation in conforming tax avoidance among public firms only and find that public firms with low capital market pressure are more active in conforming tax avoidance than public firms subject to high capital market pressure.

Using this broad measure of conforming tax avoidance developed by Badertscher et al. (2019), Kara et al. (2023) provide further insights on how the risk-taking and value-creating incentives of managers affect their decisions to implement tax strategies that result in lower book income. They argue that the benefits of conforming tax avoidance are similar to those of nonconforming tax avoidance in the way that it leads to higher future cash flows, thereby increasing firm value, and that the risks of conforming tax avoidance are unique, mainly coming from the disruption of operations and divergent investor expectations. Consistent with linking managerial wealth to stock price volatility (i.e. vega) incentivising managerial risk-taking (Coles, Daniel and Naveen 2006), Kara et al. (2023) find that vega encourages conforming tax avoidance. They also find that linking managerial wealth to stock price (i.e. delta) discourages conforming tax avoidance because, while delta can increase the incentives for firm value creation (Armstrong, Larcker, Ormazabal and Taylor 2013), it also increases managers' exposure to firm risk, thus

discouraging risk-taking, especially for risk adverse managers (Armstrong et al. 2013; Chava and Purnanandam 2010; Knopf, Nam and Thornton 2002).

Availability of this new measure enables investigation of the relationship between conforming and nonconforming tax avoidance to determine whether they are complements or substitutes for firms actively engaged in tax planning. Several studies provide for the factors that drive both types of tax avoidance in the same direction. For example, Chen, Ghoul, Guedhami, Wang and Yang (2022) reveal a significant reduction in firms' nonconforming and conforming tax avoidance after cross-listing on a U.S. stock exchange. Kim, Lu and Peng (2020) find that firms subject to higher short-selling pressure become more reluctant to reduce tax burden through either nonconforming or conforming tax strategies. Na and Yan (2022) suggest that U.S. firms having CEOs born in countries with languages that grammatically distinguish the future from the present tend to engage in more nonconforming and conforming tax avoidance. In those studies, conforming tax avoidance is generally introduced as an alternative to the effective tax rate and book-tax difference measures and used to test the robustness of the main results. Their findings suggest that firms could complement nonconforming with conforming tax strategies.

However, there are also studies that document the circumstances in which firms exchange nonconforming tax avoidance for the arguably less risky conforming tax avoidance. Focusing on national elections around the world, Li, Maydew, Willis and Xu (2022) expect and find that firms increase nonconforming tax avoidance (measured by a modified ETR) in election years due to the increased uncertainty regarding post-election tax policies and economic conditions. But they provide empirical evidence of decreased conforming tax behaviour in election years, which seems to indicate switching from tax strategies that increase tax savings at the expense of reporting lower earnings to strategies that increase both book earnings and taxable earnings. Another illustration is in the event of corporate tax rate cuts. Lower tax rates would result in lower benefits of conforming tax avoidance and therefore make nonconforming tax avoidance more attractive. In fact, Eichfekder et al. (2024) find a substantial reduction in conforming tax avoidance for firms in European countries that have lowered their corporate statutory tax rates. Collectively, these results imply that firms in specific situations might choose to substitute conforming for nonconforming tax avoidance.

2.2 SEC Tax-Related Comment Letters

The Sarbanes-Oxley Act of 2002 requires the SEC to review the periodic filings of public firms at least once every three years. In their review process, the SEC issues comment letters when they identify any deficiencies or ambiguities in firms' financial statements. Those comments, together with firms' responses to them, are made publicly available on SEC's EDGAR website once all issues raised are properly addressed and resolved. As the SEC's primary responsibility is enhancing corporate reporting quality, prior research on the effects of SEC comment letters tends to focus on disclosure changes following a comment letter review. Specifically, firms that receive comment letters have been found to improve qualitative disclosures (Bozanic, Dietrich and Johnson 2017), reduce uncertainty in fair value estimates (Bens, Cheng and Neamtiu 2016), increase reporting consistency with their industry peers (Brown, Tian and Tucker 2018), and experience lower analyst forecast errors (Wang 2016). In addition, there are also papers that examine how the SEC review process induces changes in firms' accounting and operating practices, such as, accrual and real earnings management (Cunningham et al. 2020), financial restatements (Blackburne 2014), write-downs of goodwill (Ryans 2018), and CEO compensation (Robinson, Xue and Yu 2011).

Firms' tax disclosures and accounting for income taxes continue to be one of SEC's top areas of concern in the comment letter process (Deloitte 2017; Ernst and Young 2018). One line of research investigates the determinants of SEC tax-related comment letters. Kubick et al. (2016) find that firms engaging in greater tax planning are more likely to receive comment letters on their tax disclosures. Eiler and Kutcher (2016) demonstrate that U.S. multinationals with larger amounts of permanently reinvested earnings have a higher probability of receiving comment letters on their foreign operations and tax practices. Another line of research focuses on the consequences of receiving tax-related comment letters and their resolution. The results from Kubick et al. (2016) show that close scrutiny of tax-related financial statement disclosures by the SEC leads to a reduction in future nonconforming tax avoidance. This change in firms' tax planning behaviour negatively affects their future cash flows and therefore results in a negative investor reaction around the public release of tax-related comment letters (Edwards et al. 2019). Moreover, when firms are requested to revise their tax disclosures in the SEC comment letter process, Ehinger (2020) provides evidence of a decrease in the informativeness of such disclosures and a decrease in analyst ETR forecast accuracy.

Even though the SEC is not concerned about corporate tax avoidance, which is the main focus of the IRS, regulatory scrutiny of tax-related financial reporting could have a spillover effect

on firms' tax strategies if it increases the enforcement costs of tax avoidance (Kubick et al. 2016; Edwards et al. 2019). A number of papers have shown that the IRS uses tax-related public information, including firms' 10-K filings (Bozanic et al. 2017), financial restatements (Fox and Wilson 2022), book-tax differences (Mills and Sansing 2000), and tax reserve disclosures (Mills, Robinson and Sansing 2010) to target specific tax avoidance activities in its audit process. To the extent that the SEC comments on critical tax disclosure issues and that the firms provide additional tax information in their responses, the IRS can rely on the tax-related comment letter conservations to help identify and select firms for examination. This expected increase in IRS audit probability might increase the costs of tax avoidance for firms resolving a tax-related comment letter and lead to a real change in corporate tax decisions.

3. HYPOTHESIS DEVELOPMENT

Prior research finds that the tax-related SEC comment letters are negatively associated with firms' nonconforming tax avoidance behaviour (Kubick et al. 2016). This is because SEC scrutiny of financial statement tax disclosures increases the likelihood of the scrutinised firms' tax positions being challenged and overturned by tax authorities (Kubick et al. 2016, Edwards et al. 2019). Though tax authorities have access to their own sets of information, prior research illustrates their attention to publicly available financial information, including SEC comment letters, to facilitate their choice of firms or issues for examination (Bozanic et al. 2017; Fox and Wilson 2022). To the extent that the tax-related comments could potentially help identify tax planning activities to target during tax audits, there are increased enforcement costs of nonconforming tax avoidance following SEC scrutiny (Kubick et al. 2016). But tax avoidance, which generates cash tax savings, may be beneficial to shareholders as long as the expected benefits outweigh the costs. Therefore, when tax-related regulatory scrutiny increases the costs of nonconforming tax avoidance, shareholders may prefer firms to switch to other, less costly, forms of tax avoidance strategies.

Firms can avoid taxes in a variety of ways, from something like investments in the tax-exempt municipal bond, which are perfectly in compliance with the tax law, to tax planning activity that is described as "evasion", "aggressiveness" or "sheltering" (Hanlon and Hertzman 2010). Conforming tax avoidance is residing closer to the less aggressive end of the tax avoidance continuum as it usually reduces tax liabilities without contentious application of tax laws (Kara et al. 2023; Mills 1998), thus leading to lower probability of examination and detection from

tax authorities. Therefore, conforming tax avoidance involves less enforcement costs, such as the costs used to negotiate with tax authorities and settle possible tax audits, making it more appealing for those firms subject to SEC scrutiny. While conforming tax avoidance generates cash tax savings, it also has the consequence of reporting lower income to shareholders. Provided that shareholders are able and willing to accept the lower reported income associated with conforming tax planning, it can be used as an opportunity for firms to respond to increased regulatory scrutiny from the SEC.

Managers need strong incentives to switch to conforming tax planning because it can be costly along a number of dimensions. As the reduction in tax burden is at the expense of a decrease in book income, conforming tax strategies come with financial reporting costs, such as debt covenant violations or executive compensation contract incentives that are generally affected by reported earnings (Kara et al. 2023; Eichfekder et al. 2024). At the same time, the difficulty to credibly communicate the reduction in the present value of taxes likely impairs investors' and analysts' forecasts of future firm performance, thus reducing share price, increasing stock price volatility and trading volume (Kara et al. 2023). Furthermore, conforming tax avoidance increases operational costs because delaying revenues or accelerating expenses likely involve the disruption of operation (Badertscher et al. 2019; Kara et al. 2023).

If shareholders and managers have differential preference for conforming tax avoidance, then mechanisms that align managers' incentives to shareholders' interests can be used to influence the decisions to avoid taxes in a book-tax conforming manner. For example, linking executive wealth to stock price volatility may incentivise managers to overcome risk aversion and invest in more conforming tax avoidance to avoid paying additional taxes (Kara et al. 2023). This type of equity incentive alleviates managers' concerns that conforming tax avoidance has a negative effect on their compensation and lowers their pressure to report increased earnings. Furthermore, certain governance mechanisms such as external monitoring through institutional shareholders and internal monitoring through independent boards are also expected to increase tax avoidance in the interest of shareholders (Armstrong, Blouin, Jagolinzer and Larcker 2015; Kovermann and Velte 2019). With effective monitoring in place, managers are better protected from any penalties resulting from reporting lower income for the benefits of reducing tax liabilities and investors are more likely to understand any positive effect of conforming tax avoidance on firm value.

Overall, when managerial discretion is more constrained for nonconforming tax avoidance due to the increased enforcement costs associated with tax-related SEC scrutiny, managers are likely to shift to other less costly tax strategies, including conforming tax avoidance. This expectation can be expressed as the following hypothesis:

Hypothesis: Firms have higher levels of conforming tax avoidance following the resolution of SEC tax-related comment letters.

4. RESEARCH DESIGN

4.1 Data and Sample

The primary sample consists of SEC comment letters issued on firms' 10-K and 10-Q filings in the Audit Analytics database received by firms that have firm-year data available in the Compustat Annual files for the period 2004-2020. This sample begins in 2004 as this is the first year that the SEC makes comment letter conversations publicly available. Consistent with prior research (Kubick et al. 2016; Badertscher et al. 2019), financial (two-digit SIC codes 60-69) and utility (two-digit SIC codes 48-49) firms are excluded due to different regulatory and institutional structures. Firms with negative pre-tax book income are also excluded because they face different tax incentives compared to profitable firms (Dyreng et al. 2008). To estimate the difference-in-differences regression, we require each sample firm to have at least one valid observation before and after the resolution of a comment letter and drop firm-year observations that have missing data to compute the variables entered into Equation (3).

To identify firms that have received tax-related comment letters, we use the taxonomy provided by Audit Analytics and search the list of issue keys for 214, 897, 213, 560, 561, 595, 596, 275, 397, 398, 403, 399, 400, 401, 402, 404, 405, 406, 407, 1475, 1206, 893, 1398, 1229 and 921 (Edwards et al. 2019) as well as the list of issue phrases for terms "Tax", "FIN 48" "FAS 109" "ASC 740" (Kubick et al. 2016). Further, we also conduct a separate search of these keywords in the comment letters available on the SEC's EDGAR website to ensure identification of all possible tax-related comment letters. A comment letter is considered to be tax-related if there is at least one tax comment included in the letter issued by the SEC. The distribution of tax-related comment letters by fiscal year and industry for the difference-in-differences regression is presented in Panel B and C of Table 2.

4.2 Measures of Tax Avoidance

Following Kubick et al. (2016), three common proxies are used to measure nonconforming tax avoidance: GAAP ETR, cash ETR, and permanent book-tax differences. GAAP ETR (*ETR*) is the ratio of tax expense to pre-tax income and captures permanent differences between book and taxable income. Cash ETR (*CETR)* is calculated as cash taxes paid divided by pre-tax income and reflects the impact of both permanent and temporary tax strategies. *ETR* and *CETR* that fall outside the range of [0, 1] are excluded from our sample to ensure a valid interpretation of the results. Permanent book-tax differences (*PBTD*) is measured as pre-tax income minus estimated taxable income, minus minority interest in earnings and minus deferred taxes, then scaled by lagged total assets. *ETR* and *CETR* are decreasing in nonconforming tax avoidance and *PBTD* is increasing in nonconforming tax avoidance.

Following Badertscher et al. (2019), conforming tax avoidance (*Conform_Tax*) is estimated as the residual (ε) from the following ordinary least squares regression by three-digit NAICS code and fiscal year combinations, requiring at least 10 observations for each combination:

$$TTA_{i,t} = \beta_0 + \beta_1 BTD_{i,t} + \beta_2 NEG_{i,t} + \beta_3 BTD_{i,t} \times NEG_{i,t} + \beta_4 NOL_{i,t-1} + \beta_5 \Delta NOL_{i,t-1} + \varepsilon_{it} \quad (1)$$

TTA is the ratio of cash taxes paid to lagged total assets, which captures both conforming tax behaviour that reduces book and taxable income and nonconforming tax behaviour that reduces taxable income but not book income. To isolate the effect of conforming tax strategies, this ratio is regressed on total book-tax differences (*BTD*), which is a measure of nonconforming tax avoidance, and the level of and change in net operating losses (*NOL*, Δ*NOL*). Specifically, *BTD* is calculated as the difference between pre-tax accounting income and estimated taxable income. *BTD* is interacted with *NEG*, an indicator variable that equals 1 for negative book-tax differences and 0 otherwise, to account for the possibility that positive and negative book-tax differences may have differential impact on *TTA*. *NOL* and Δ*NOL* are included as controls for the reason that net operating loss carryforwards, which reduce *TTA*, do not indicate conforming tax avoidance. The residual, *Conform_Tax*, captures conforming tax strategies that boost a firm's total tax avoidance level above the expected industry-year average after removing the impact of nonconforming tax strategies and other factors. *Conform_Tax* is decreasing in conforming tax avoidance and *TTA* is decreasing in total tax avoidance.

Equation (1) is estimated using all firm-year observations available on Compustat, excluding observations for financial institutions or firms in highly regulated industries, observations with negative *TTA* and negative pre-tax income, and observations that have missing data to calculate the necessary variables. These data requirements generate 28,225 firm-years for the period 2004-2020, which allow me to estimate 781 separate industry-year regressions by three-digit NAICS industry and fiscal year combinations. Table 1 Panel A provides descriptive statistics for all the variables included in Equation (1), Panel B reports Pearson correlation coefficients among these variables, and Panel C shows the results for the 781 regressions used to calculate firm-year values of *Conform_Tax*. Consistent with Badertscher et al. (2019), we find that book-tax differences and net operating losses are negatively associated with cash taxes paid. This is evident in their negative correlations with *TTA* (as shown in Panel B) and also the negative mean and median coefficients on *BTD* and *NOL* (as shown in Panel C). Additionally, 54.67 percent of the coefficients on the interaction between *BTD* and *NEG* is positive, suggesting that firms with taxable income exceeding book income pay more taxes. The mean value of the residual is zero for this large sample of firm-year observations used to estimate the conforming tax avoidance measure (*Conform_Tax*).

[Insert Table 1]

4.3 Propensity Score Matching

To examine the hypotheses, firms receiving a tax-related comment letter ("Treatment") are matched to firms receiving a non-tax-related comment letter ("Control"). This propensity score matching design isolates the treatment effect of tax-related SEC regulatory scrutiny. Consistent with Kubick et al. (2016), the following logit model is used to construct the matched sample:

$$TAXCOMMLETT_{i,t} = \gamma_0 + \gamma_1 ETR_{i,t} + \gamma_2 CETR_{i,t} + \gamma_3 PBTD_{i,t} + \gamma_4 Foreign_{i,t} + \gamma_5 Volatility_{ETR\,i,t} + \gamma_k SOX408_{i,t} + \gamma_k Auditor_{i,t} + \gamma_k Governance_{i,t} + \gamma_k FirmCharacteristics_{i,t} + \gamma_k IndustryScrutiny_{i,t} + \varepsilon_{i,t} \quad (2)$$

The dependent variable (*TAXCOMMLETT*) is an indicator variable that equals 1 if the firm receives a tax-related comment letter and 0 if the firm receives a non-tax-related comment

letter. The independent variables include proxies for tax avoidance and tax uncertainty (*ETR*, *CETR*, *PBTD*, *Volatility_ETR*), presence of foreign operations (*Foreign*), determinants of SEC comment letters (*SOX408*, *Auditor*, *Governance*, *FirmCharacteristics*) and SEC attention on specific industries (*IndustryScrutiny*). Exact matching is required on industry and year and nearest-neighbour matching is used on all other covariates without replacement. We employ a caliper of 0.30 and remove any matched pairs that fall outside common support. Table 2 Panel A presents the covariate balance of these variables entered in Equation (2). The means and medians (with few exceptions) are not statistically different ($p > 0.10$) between the Treatment and Control firms, indicating that the matched pairs are balanced. Panels B and C confirm that the Treatment and Control firms are matched by fiscal year and industry (two-digit SIC) with equal number of firms presented in each row. This propensity score matched sample includes 518 Treatment and 518 Control firms (i.e. a total of 1036 firms), corresponding to 5,926 firm-year observations with non-missing data for the variables in Equation (3).

[Insert Table 2]

4.4 Difference-in-Differences Model

Using this matched sample of firms, the following difference-in-differences model is estimated to investigate the effects of SEC tax-related comment letters:

$$Conform\_Tax_{i,t}/ETR_{i,t}/CETR_{i,t}/PBTD_{i,t}/TTA_{i,t} = \alpha_0 + \alpha_1 TAXCLFIRM_i + \alpha_2 POST_{i,t} + \alpha_3 TAXCLFIRM_i \times POST_{i,t} + \alpha_k Controls_k + \tau_t + \lambda_j + \varepsilon_{i,t} \quad (3)$$

The dependent variable is one of the measures of conforming tax avoidance (*Conform_Tax*), nonconforming tax avoidance (*ETR*, *CETR*, *PBTD*), or total tax avoidance (*TTA*), defined previously. *TAXCLFIRM* is an indicator variable that equals 1 for tax-related comment letter firms and 0 for non-tax-related comment letter firms. *POST* is an indicator variable that equals 1 for fiscal years after the resolution of each firm's individual comment letter, and 0 otherwise. Thus, *TAXCLFIRM* × *POST* is the difference-in-differences estimator that reflects the effects of tax-related regulatory scrutiny on conforming, nonconforming and total tax avoidance, after controlling for firms' tax avoidance levels before resolving the comment letter and the generic regulatory scrutiny of firms resolving other types of comment letters. According to our hypothesis, the coefficient (α_3) on this interaction term is expected to be negative for the

Conform_Tax model and positive (negative) for the *ETR* or *CETR* (*PBTD*) model. There is no prediction for the sign of coefficient for the *TTA* model.

We also control for an array of variables following Kubick et al. (2016) and provide detailed variable definitions in Appendix A. Year and industry (two-digit SIC) fixed effects are included and robust standard errors are used in estimating Equation (3).

5. EMPIRICAL ANALYSIS

5.1 Main Results

Figure 1 provides some preliminary evidence on the effects of tax-related comment letters on nonconforming and conforming tax avoidance. We plot the mean values of *ETR* (Figure 1.1) and *Conform_Tax* (Figure 1.2) for a seven-year period (i.e. from *t-3* to *t+3*) for all the tax-related comment letter observations. Recall that an increase (decrease) in *ETR* means a decrease (increase) in nonconforming tax avoidance, and a decrease (increase) in *Conform_Tax* means an increase (decrease) in conforming tax avoidance. Figure 1.1 shows a decreasing trend in *ETR* in the years prior to resolving the tax-related comment letter and an increasing trend after the tax-related comment letter resolution. In contrast, we observe from Figure 1.2 an increase in *Conform_Tax* in the pre-period (year *t-3* to *t*) and a decrease in the post-period (year *t* to *t+3*). These patterns offer initial insights consistent with firms engaging in more conforming tax strategies but less nonconforming tax strategies following tax-related SEC comment letters, supporting our hypothesis.

[Insert Figure 1]

Table 3 reports the descriptive statistics (in Panel A) for the sample of Treatment and Control firms formed from estimating Equation (2) and the test results (in Panel B) using the difference-in-differences model as specified by Equation (3). The distribution of *ETR*, *CETR*, *PBTD* and the control variables are consistent with Kubick et al. (2016). The mean and median values of *Conform_Tax* and *TTA* are consistent with prior studies (Badertscher et al. 2019; Kara et al. 2023). We find a significantly negative coefficient on the interaction term *TAXCLFIRM* × *POST* ($\alpha_3 = -0.002$; p = 0.018) in the *Conform_Tax* regression. This suggests that firms increase their levels of conforming tax avoidance after resolving a tax-related comment letter,

compared with firms resolving a non-tax-related comment letter, which is consistent with our hypothesis. We also find a significantly positive coefficient on *TAXCLFIRM* × *POST* (α_3 = 0.013; p = 0.018) in the *ETR* regression and a significantly negative coefficient on *TAXCLFIRM* × *POST* (α_3 = −0.004; p = 0.031) in the *PBTD* regression. Both of these coefficient estimates indicate a reduction in firms' nonconforming tax behaviour following tax-related comment letters, confirming the findings in Kubick et al. (2016) and providing support for our hypothesis. In addition, the coefficient on the difference-in-differences estimator is not significantly different from zero (α_3 = −0.001; p = 0.208) in the *TTA* regression. Thus, we fail to observe a significant change in the tax comment letter firms' total tax avoidance activities, relative to the non-tax comment letter firms.

[Insert Table 3]

We also investigate the parallel trends in all the tax variables between Treatment and Control firms to validate the appropriateness of the difference-in-differences methodology. Following Roberts and Whited (2012), we perform paired sample t-tests of the difference in the percentage growth rates of our five dependent variables in the pre-treatment period. Comparing the means between our Treatment and Control groups, we observe statistically insignificant difference for *Conform_Tax* (p = 0.256), *ETR* (p = 0.532), *CETR* (p = 0.688), *PBTD* (p = 0.191), and *TTA* (p = 0.423), which provides some assurance for the difference-in-differences design. Further, we examine the parallel trends assumption by adding two additional sets of interaction terms to Equation (3) for the two years preceding tax-related comment letters. As shown in Appendix B, we continue to find statistically significant coefficients on *TAXCLFIRM* × *POST* with signs consistent with our main results after controlling for *TAXCLFIRM* × PRE_{t-1} and *TAXCLFIRM* × PRE_{t-2}, where PRE_{t-1} equals 1 for year *t-1* and PRE_{t-2} equals 1 for year *t-2* prior to the tax comment letter resolution. The statistically insignificant coefficients on the newly included interaction terms in the *Conform_Tax*, *ETR* and *PBTD* regressions suggest that those three tests satisfy the parallel trends assumption necessary for a valid difference-in-differences estimation.

5.2 Robustness Tests

To provide further evidence that the effects on conforming tax avoidance are attributable to tax-related comment letters rather than an unknown past event or general time trends, we repeat

the differences-in-differences analysis on the pre-event years, following Roberts and Whited (2012). Specifically, we falsely assume that the resolution of tax-related comment letters occurs one (or two or three) year before the actual event year and re-estimate Equation (3) by replacing *POST* with *PSEUDO_POST*, which equals 1 if the firm resolves the assumed comment letter in year *t-1*, *t-2* or *t-3* and zero otherwise. As reported in Appendix C, all the coefficients on the difference-in-differences estimators *TAXCLFIRM* × *PSEUDO_POST1* (α_3 = −0.001; p = 0.113), *TAXCLFIRM* × *PSEUDO_POST2* (α_3 = −0.001; p = 0.160), and *TAXCLFIRM* × *PSEUDO_POST3* (α_3 = −0.001; p = 0.346) do not differ significantly from zero. Our failure to find a statistically significant relation between the pseudo-events and changes in conforming tax avoidance provide additional support that the effect of tax-related comment letters appears in the year of comment letter and not in previous years.

Our main findings of a decrease in nonconforming tax avoidance and an increase in conforming tax avoidance seems to suggest a trade-off between two different types of tax strategies after a firm resolves a tax-related comment letter. To provide additional evidence on when a firm is more likely to switch their tax strategies, we partition the main sample using the increase in ETR from *t* to *t+1* and show the results of estimating Equation (3) for both sub-samples in Table 4. For firms that have a larger increase in ETRs (i.e. a greater reduction in nonconforming tax avoidance), they tend to engage in more conforming tax avoidance. However, the coefficients on *TAXCLFIRM* × *POST* is not significantly different from zero for the sample of firms that have a smaller increase in ETRs because the benefits of additional tax savings may not be enough to cover the costs of changing from one tax strategy to the other.

[Insert Table 4]

5.3 Cross-Sectional Analyses

Prior research on the effect of tax-related comment letters only focuses on nonconforming tax avoidance (Kubick et al. 2016; Edwards et al. 2019). This provides an incomplete picture by showing that firms reduce tax planning as a result of increased SEC scrutiny, while in fact, they may simply be substituting nonconforming tax activities with conforming tax activities. To better understand the mechanisms underlying the association between tax-related regulatory scrutiny and conforming tax avoidance, we perform a number of cross-sectional tests

examining the circumstances in which managers have more incentives to use conforming tax strategies.

For public firms that require external financing, the extent to which they engage in book-tax conforming tax avoidance can be influenced by capital market pressure. Prior studies suggest that capital market pressure affects managers' tax decisions (Penno and Simon 1986; Cloyd et al. 1996; Mills and Newberry 2001). Badertscher et al. (2019) find that, when market pressure is low, public firms engage in more book-tax conforming as opposed to nonconforming tax avoidance. These low market pressure public firms are less likely to suffer from reporting lower pre-tax income and more likely to find the benefits of conforming tax strategies to outweigh the costs of nonconforming tax strategies. In the event of increased enforcement costs, which are mainly associated with nonconforming but not really conforming tax behaviour, managers in high market pressure firms would perceive nonconforming tax avoidance as particularly costly and therefore more willing to switch to tax planning in a book-tax conforming manner.

Consistent with Badertscher et al. (2019), we predict that firms subject to lower capital market pressure engage in more conforming tax avoidance and less nonconforming tax avoidance, especially when the tax-related comment letters increase the expected costs of nonconforming tax avoidance. We examine the influence of capital market pressure by partitioning the main sample based on 1) whether there is stock issuance (*StockIssue*), 2) number of analysts following (*AnalystFollow*) above and below the sample median, 3) sales growth rate (*SALESGR*) above and below the sample median, 4) discretionary accruals (*ACC*) in the top and bottom quartile, and estimate Equation (3) within each partition. Results for each of the separate estimations are reported in Table 5. When facing lower capital market pressure, as proxied by no stock issuance, less analysts following, smaller sales growth, and lower discretionary accruals, we find that conforming tax avoidance is greater after the resolution of tax-related comment letters. But the same effect does not exist for firms facing higher capital market pressure. This finding is consistent with managers unwilling to avoid taxes in a book-tax conforming manner when there is greater pressure to report higher earnings in their financial statements.

[Insert Table 5]

Conforming tax avoidance is constrained by the pressure to report higher earnings. In addition to earnings pressure from the capital markets, there could also be earnings pressure from debt holders, such as banks, through the presence of earnings-related financial covenants (Dichev and Skinner 2002; Franz, HassabElnaby, and Lobo 2014). We expect that firms subject to those covenants are less likely to avoid taxes in a book-tax conforming manner. Conforming tax avoidance would make firms report lower earnings in financial statements which might lead to potential breach of those earnings-related covenant provisions. As the benefits of conforming strategies are smaller for firms with earnings pressure from debt covenants, managers in those firms may be less willing to engage in conforming tax planning to compensate for the anticipated reduction in nonconforming tax planning following the resolution of tax-related SEC comment letters.

Accordingly, firms that are subject to debt market pressure to report higher earnings are expected to be reluctant to engage in conforming tax avoidance. We divide the main sample into sub-samples depending on whether the firm has a loan contract that contains a financial covenant (*FinCovenants*) and whether the covenant is earnings-related (*EarCovenants*). We define earnings-related covenants as those including interest coverage ratio and fixed charge coverage ratio.[1] As reported in Table 6, the increase in conforming tax avoidance activities following tax-related SEC comment letters, as evidenced by negative and significant coefficients on *TAXCLFIRM* × *POST*, is present only for the sub-sample of firms without financial and earnings-related debt covenants. In contrast, the significantly positive coefficient on the interaction term (α_3 = 0.005; p = 0.097) in column (3) indicate that firms subject to earnings-related covenants tend to reduce conforming tax avoidance following tax-related comment letters.

[Insert Table 6]

The incentives to avoid taxes could also vary based on executive equity compensation because executives play a critical role in shaping firms' tax strategies (Rego and Wilson 2012; Dyreng, Hanlon and Maydew 2010). High CEO wealth sensitivity to stock price volatility (i.e. vega)

[1] Interest coverage ratio measures a firm's ability to pay the interest on its outstanding debt and is calculated by dividing earnings before interest and taxes by interest expense. Fixed charge coverage ratio measures a firm's ability to meet fixed charges, including insurance premiums, lease and loan payments, from its earnings before interest and taxes.

has been found to encourage risk-taking and motivate conforming tax avoidance (Kara et al. 2023). In contrast, high CEO wealth sensitivity to stock price (i.e. delta) may expose CEOs to firm risks and discourage any conforming tax decisions that may result in a decrease in stock price (Kara et al. 2023). Therefore, for firms with high vega and low delta, the net present value of the tax savings associated with conforming tax avoidance is likely to be higher than that of nonconforming tax avoidance. This prediction is expected to hold in the circumstances where tax-related regulatory scrutiny increases the costs of nonconforming tax strategies, making strategies that reduce both book and taxable income more appealing.

We focus on equity incentives because tax-related managerial decisions depend partly on the degree of interest alignment between executives and shareholders. Table 7 Panel A shows the results from estimating Equation (3) after splitting the sample based on vega and delta above (High *CEOVega*, High *CEODelta*) and below (Low *CEOVega*, Low *CEODelta*) the sample average. Following Coles, Daniel and Naveen (2006), *CEOVega* (*CEODelta*) is calculated as the change in the value of a CEO's option portfolio for a one percentage point change in stock price volatility (stock price) and captures CEO wealth sensitivity to stock price volatility (stock price). Consistent with vega incentivising managerial risk-taking behaviour, we find an increase in firms' conforming tax avoidance following tax-related comment letters when there are higher *CEOVega* incentives. Consistent with delta exposing managers to firm risk, we also find that the increased conforming tax avoidance is only present for the low *CEODelta* sub-sample. Overall, the results are in line with the evidence in Kara et al. (2023) of a positive relation between vega and conforming tax avoidance and a negative relation between delta and conforming tax avoidance. Panel B provides additional support to our results that firms appear to link CEO wealth to stock price volatility rather than stock price following SEC tax-related comment letters, which provide the incentives for managers to engage in more conforming tax avoidance activities.

[Insert Table 7]

As shareholder and managers have divergent interests in tax avoidance, shareholders may implement mechanisms to monitor and influence managers' tax decisions. Extant evidence on the relation between managerial monitoring mechanisms and nonconforming tax avoidance is mixed. There are studies that document good monitoring prevents aggressive tax planning (Lanis and Richardson 2011; Richardson, Lanis and Taylor 2013) and also studies that support

for managers in well-monitored firms having more incentives to avoid taxes (Desai and Dharmapala 2006; Taylor and Richardson 2014; Richardson, Lanis and Taylor 2015). Those conflicting findings are consistent with shareholders preferring the tax savings but opposing the tax risks associated with tax planning. Unlike nonconforming tax avoidance, conforming tax avoidance does not involve contentious applications of tax law, making it more difficult to be detected and challenged by the tax authorities. Good monitoring mechanisms, while they may constrain managers' investment in the risky forms of nonconforming tax avoidance, are more likely to encourage managers to invest in the less risky conforming tax avoidance by aligning managerial incentives to shareholder interests.

Thus, we posit that good investor and board monitoring mechanisms motivate the less risky conforming tax avoidance in the event of increased regulatory scrutiny of tax-related financial disclosures. Table 8 presents results for comparisons of conforming tax avoidance at firms that have large versus small percentage of nontransient institutional investors (*InstPercNonTrans*), high versus low proportion of independent directors on corporate board (*BoardIndPct*), and more versus less board meetings (*BoardMtgs*). Consistent with our prediction, the coefficients on *TAXCLFIRM* × *POST* are negative and significant for those firms that are subject to greater monitoring mechanisms, as reflected by higher institutional ownership, greater independence in boards and more board meetings. However, the coefficients are not significantly different from zero for the sub-sample of firms that are subject to less monitoring. In addition, we use these three measures of investor and board monitoring, and conduct a principal component analysis to construct a monitoring index (*PC*) for each firm. Results in column (7) and (8) show that well-monitored firms in the top quartile engage in more conforming tax avoidance following tax-related SEC scrutiny but there is no empirical evidence for increased level of conforming tax avoidance for those firms in the bottom quartile of the monitoring index.

[Insert Table 8]

5.4 Further Analyses

As conforming tax avoidance is achieved through a similar reduction in financial and taxable income, we expect managers to use tax-motivated earnings management strategies to manipulate earnings downward following tax-related comment letters. To investigate how the tax comment letter firms' income is reduced in a book-tax conforming manner, we test the

effects of SEC scrutiny on one proxy for accrual earnings management and three proxies for real earnings management by estimating the following difference-in-differences model:

$$ACC_{i,t}/DISCR\_CFO_{i,t}/DISCR\_EXP_{i,t}/DISCR\_PROD_{i,t} = \alpha_0 + \alpha_1 TAXCLFIRM_i + \alpha_2 POST_{i,t} + \alpha_3 TAXCLFIRM_i \times POST_{i,t} + \alpha_k Controls_k + \tau_t + \lambda_j + \varepsilon_{i,t} \quad (4)$$

Following Frank et al. (2009), *ACC* is discretionary accrual and captures changes in accounting methods or estimates used to report the transactions in financial statements. Consistent with Roychowdhury (2006), *DISCR_CFO* is discretionary cash flow from operations and captures manipulation of the timing of sales; *DISCR_EXP* is discretionary expenses, which include research and development expenses, advertising expenses, selling, general and administrative expenses; *DISCR_PROD* is discretionary production and captures changes in cost of goods sold and inventory. The interaction term *TAXCLFIRM* × *POST* is the difference-in-differences estimator and control variables are adapted from Equation (3). If managers use their discretion over accounting choices to reduce both book and taxable income, we expect the coefficient on *TAXCLFIRM* × *POST* to be negative and significant in the *ACC* regression. If managers use their discretion over real activities manipulation to reduce both book and taxable income, we expect to find a significantly negative (positive) coefficient on the difference-in-differences estimator in the *DISCR_CFO* (*DISCR_EXP* and *DISCR_PROD*) regression.

Table 9 Panel A provides the results from these regressions. We fail to find evidence of a change in discretionary accruals following tax-related SEC scrutiny. Consistent with managers altering real transactions to delay the timing of sales and increase the reported cost of goods sold, the coefficient on *TAXCLFIRM* × *POST* is negative (α_3 = −0.010; p = 0.010) and significant in the *DISCR_CFO* regression and is positive (α_3 = 0.037; p = 0.001) and significant in the *DISCR_PROD* regression.[2] Our results indicate that firms resolving tax-related comment letters are likely to reduce income in a book-tax conforming manner through tax-motivated downward real earnings management. Further, Panel B presents the results from re-estimating Equation (3) after adding three proxies of real earnings management to the *Conform_Tax*

[2] The coefficients on *Post* are indistinguishable from zero for all regressions, suggesting that there is no evidence of a change in real earnings management (REM) or accrual earnings management (AEM) for non-tax-related comment letter firms. This finding is inconsistent with Cunningham et al. (2019) which find that firms increase REM and decrease AEM after receiving SEC comment letters. The reason for this inconsistency is that our control sample consists of firms that are larger in size and more profitable (as we have excluded loss firms from our sample to ensure a valid interpretation of the tax variables) than the sample in Cunningham et al. (2019) which includes all firms that have received comment letters in their sample period.

regression. Compared with a baseline model shown in column (1), the coefficient on *TAXCLFIRM* × *POST* increases 0.04 percentage points from −0.0025 to −0.0021, which confirms that the measure of conforming tax avoidance captures book-tax conforming strategies that include real-activities-based downward earnings management.

[Insert Table 9]

6. CONCLUSION

This study examines the impact of tax-related SEC scrutiny on firms' tax avoidance strategies. We find that a tax-related SEC comment letter leads to a decreased level of nonconforming tax activities, and an increased level of conforming tax activities undertaken by the recipient firm. Managers of these tax comment letter firms tend to switch to the less risky and less costly way to avoid taxes in a book-tax conforming manner. The higher conforming tax avoidance acts as a substitute for the lower nonconforming tax avoidance because we do not find evidence of any change in total tax avoidance following tax-related comment letters.

To provide context to the association between the resolution of tax-related comment letter and conforming tax avoidance, we perform a number of cross-sectional tests. Firms that are subject to greater market pressure are found to engage in more conforming tax avoidance following tax-related comment letters. Firms that are not subject to debt covenants are more willing to avoid taxes in a book-tax conforming manner. Our results also suggest that vega encourages conforming tax avoidance and delta discourages conforming tax avoidance in the event of tax-related comment letters. In addition, we find that monitoring from investors and the board have a positive influence on managers' willingness to engage in the less detectable conforming tax avoidance to maintain a satisfactory level of cash tax savings for the benefits of shareholders.

The results of our study should be informative to tax authorities such as the IRS as they offer a more complete picture of whether and how scrutiny of tax-related financial disclosures affect managers' tax avoidance decisions. To the extent that the IRS pays attention to the publicly available SEC comment letters and uses them in their audit process, the IRS may want to focus on identifying tax strategies that reduce book and taxable income in a conforming manner for those tax comment letter firms. Merely examining nonconforming tax avoidance might underestimate the total level of tax avoidance. This informs that it is not enough for tax policies

to only target book-tax differences and regulators need to contemplate the availability of conforming tax strategies if they want to deter corporate tax avoidance. Moreover, this study also informs managers and investors of a setting with an increased risk for greater conforming tax avoidance when firms are constrained by higher enforcement costs to engage in nonconforming tax avoidance. While the benefits of conforming tax planning are greater for firms resolving tax-related comment letters, we note that it can also increase firm risk by reporting lower earnings and altering the nature of firm operations.

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Figure 1

Trend in Tax Avoidance Surrounding Tax-Related Comment Letters

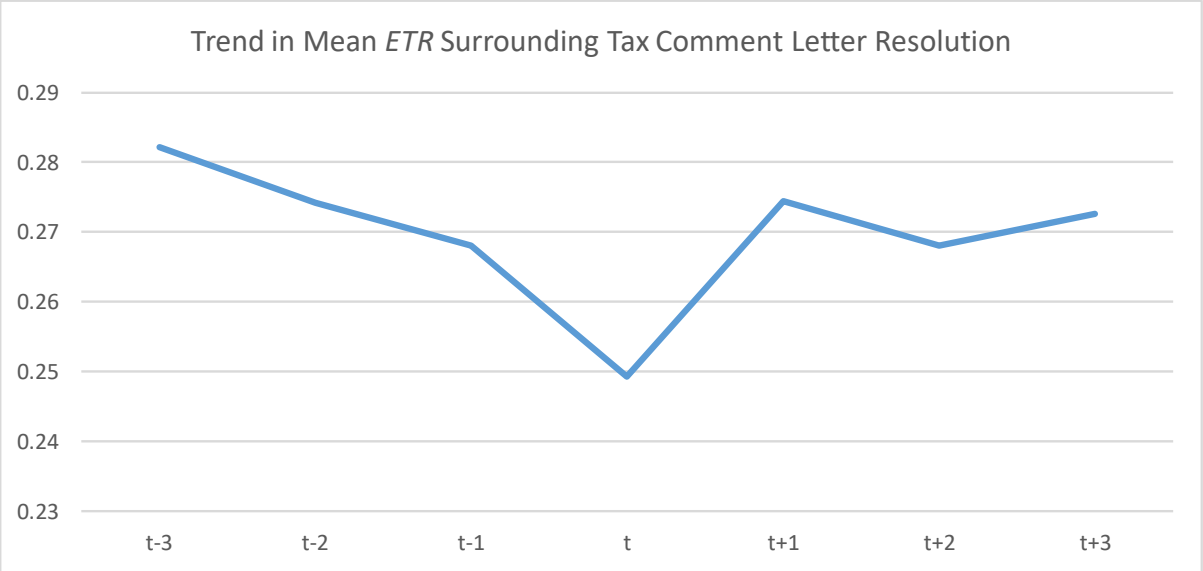

Figure 1.1 – the mean nonconforming tax avoidance trend for the three years before and three years after the year of resolving tax-related comment letters for all tax-related comment letter observations. *ETR* is decreasing in nonconforming tax avoidance.

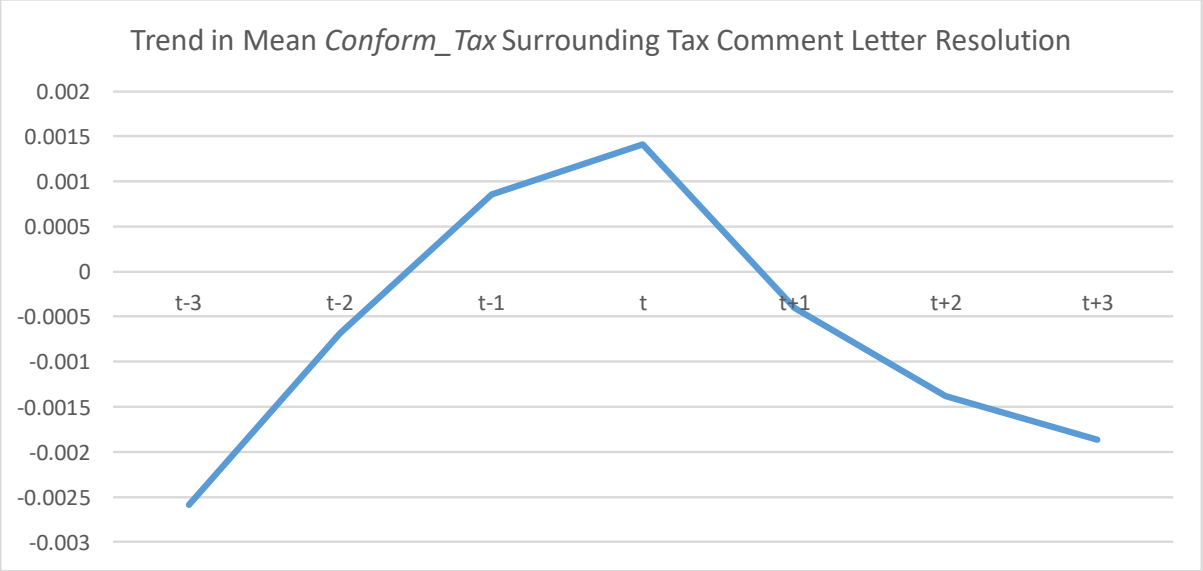

Figure 1.2 – the mean conforming tax avoidance trend for the three years before and three years after the year of resolving tax-related comment letters for all tax-related comment letter observations. *Conform_Tax* is decreasing in conforming tax avoidance.

TABLE 1

Estimation of Conforming Tax Avoidance Measure (*Conform_Tax*)

Panel A: Descriptive Statistics for Input Variables for Estimation of *Conform_Tax*

	N	Mean	SD	P25	P50	P75
TTA_{it}	28,225	0.027	0.030	0.005	0.017	0.037
BTD_{it}	28,225	0.046	0.165	-0.003	0.023	0.060
NEG_{it}	28,225	0.274	0.446	0.000	0.000	1.000
BTD_{it}×NEG_{it}	28,225	-0.017	0.060	-0.003	0.000	0.000
NOL_{it-1}	28,225	0.534	0.499	0.000	1.000	1.000
ΔNOL_{it-1}	28,225	0.014	0.133	-0.000	0.000	0.002

Panel B: Pearson Correlation for Input Variables for Estimation of *Conform_Tax*

	TTA_{it}	BTD_{it}	NEG_{it}	BTD_{it}×NEG_{it}	NOL_{it-1}	ΔNOL_{it-1}
TTA_{it}	1.000					
BTD_{it}	-0.078*	1.000				
NEG_{it}	0.021*	-0.402*	1.000			
BTD_{it}×NEG_{it}	0.021*	0.472*	-0.464*	1.000		
NOL_{it-1}	-0.179*	-0.084*	0.145*	-0.170*	1.000	
ΔNOL_{it-1}	-0.072*	0.021*	0.064*	-0.215*	0.126*	1.000

Panel C: Summary Statistics for 781 Regressions Estimating *Conform_Tax*

	Mean	SD	P25	P50	P75	Percent>0
β_0	0.032	0.022	0.018	0.029	0.042	97.82%
β_1	-0.020	0.423	-0.076	-0.022	0.024	33.55%
β_2	-0.001	0.034	-0.012	-0.000	0.013	50.70%
β_3	-0.064	1.700	-0.208	0.016	0.190	54.67%
β_4	-0.009	0.027	-0.015	-0.007	-0.001	22.02%
β_5	-0.024	0.740	-0.077	-0.009	0.042	40.08%
R^2	0.303	0.222	0.129	0.243	0.431	
Residual	0.000	0.026	-0.015	-0.004	0.008	

This sample includes all firm-year observations available on Compustat, excluding observations in financial and highly regulated industries (SIC codes 6000-6999 and 4800-4900), observations with negative ratio of cash taxes paid to lagged total assets (*TTA*) and negative pre-tax income (PI), and observations that have missing data to calculate any variable included in Equation (1). These data requirements generate a sample of 28,225 firm-year observations from 2004 to 2020. All continuous various are winsorised at the 1st and 99th percentiles. Panel A reports descriptive statistics and Panel B reports correlation coefficients for all the variables used to estimate the conforming tax avoidance measure (*Conform_Tax*). Correlations with star are significant at the 5 percent level or better (two-tailed t-test). Panel C reports summary statistics for the 781 ordinary least squares (OLS) regressions estimating Equation (1) by three-digit NAICS industry code and fiscal year combinations, requiring at least 10 observations for each regression. These 781 regressions are estimated based on the 28,225 firm-year observations in Panel A. *Conform_Tax* is calculated as the residual (ε) from these regressions.

$$TTA_{i,t} = \beta_0 + \beta_1 BTD_{i,t} + \beta_2 NEG_{i,t} + \beta_3 BTD_{i,t} \times NEG_{i,t} + \beta_4 NOL_{i,t-1} + \beta_5 \Delta NOL_{i,t-1} + \varepsilon_{it} \quad (1)$$

The dependant variable *TTA* is the ratio of cash taxes paid to lagged total assets. The independent variables include total book-tax differences (*BTD*), an indicator variable (*NEG*) equalling 1 for observations with negative book-tax differences and 0 otherwise, the interaction of *BTD* and *NEG*, and the level *(NOL*) of and change (Δ*NOL*) in net operating loss carryforwards. All variables are defined in Appendix A Panel A.

TABLE 2
Propensity Score Matched Sample Description

Panel A: Propensity Score Matching Covariate Balance

	Treatment		Control		p-value	
Variables	**Mean**	**Median**	**Mean**	**Median**	**Mean**	**Median**
ETR_{it}	0.303	0.318	0.301	0.324	0.653	0.205
$CETR_{it}$	0.244	0.224	0.241	0.240	0.632	0.035
$PBTD_{it}$	0.024	0.015	0.027	0.015	0.148	0.969
$Foreign_{it}$	0.630	1.000	0.639	1.000	0.604	1.000
$Volatility\_ETR_{it}$	0.387	0.098	0.389	0.066	0.954	0.000
M_Weak_{it}	0.164	0.000	0.173	0.000	0.538	0.538
$Restate_{it}$	0.236	0.000	0.218	0.000	0.252	0.252
$HighVolatility_{it}$	0.175	0.000	0.171	0.000	0.800	0.800
$InMarketCap_{it}$	7.236	7.424	7.228	7.215	0.924	0.029
$CompanyAge_{it}$	32.047	26.000	31.272	28.000	0.252	0.167
$Loss_{it}$	0.200	0.000	0.203	0.000	0.848	0.848
$BankruptcyRank_{it}$	3.324	3.000	3.343	3.000	0.807	0.503
$SalesGrowth_{it}$	0.120	0.085	0.129	0.082	0.202	0.564
$Segments_{it}$	2.425	1.000	2.242	1.000	0.241	0.767
$M\&A_{it}$	0.408	0.000	0.402	0.000	0.754	0.754
$Restructuring_{it}$	0.548	1.000	0.527	1.000	0.264	1.000
$ExtFinancing_{it+1}$	-0.011	0.000	-0.014	0.000	0.304	0.474
$Litigation_{it}$	0.368	0.000	0.388	0.000	0.285	0.285
$Big4_{it}$	0.819	1.000	0.798	1.000	0.157	1.000
$SecondTier_{it}$	0.079	0.000	0.086	0.000	0.486	0.485
$AudTenure_{it}$	13.724	10.000	13.100	11.000	0.105	0.317
$AuditorResigned_{it}$	0.038	0.000	0.033	0.000	0.533	0.533
$AuditorDismissed_{it}$	0.139	0.000	0.136	0.000	0.781	0.780
$IndustryScrutiny_{it}$	11.752	8.000	11.752	8.000	1.000	1.000
$InstPercNonTrans_{it}$	0.626	0.734	0.620	0.730	0.571	0.617
CEO_Chair_{it}	0.196	0.000	0.194	0.000	0.884	0.884
CFO_BOD_{it}	0.270	0.000	0.272	0.000	0.897	0.897
$BoardIndPct_{it}$	0.571	0.600	0.578	0.600	0.429	0.281
$BoardMtgs_{it}$	7.218	7.000	7.030	7.000	0.377	0.615
CFO_Tenure_{it}	2.565	2.000	2.475	2.000	0.395	0.667
CEO_Tenure_{it}	4.161	3.000	4.195	3.000	0.845	0.729

Panel B: Distribution of Matched Pairs by Year

Years	**Treatment**	**Control**	**Total**
2004	1	1	2
2005	33	33	66
2006	65	65	130
2007	46	46	92
2008	47	47	94

2009	40	40	80
2010	48	48	96
2011	49	49	98
2012	41	41	82
2013	42	42	84
2014	31	31	62
2015	17	17	34
2016	24	24	48
2017	16	16	32
2018	9	9	18
2019	7	7	14
2020	2	2	4
Total	518	518	1036

Panel C: Distribution of Matched Pairs by Industry

Two-Digit SIC	**Treatment**	**Control**	**Total**
1	1	1	2
10	2	2	4
12	1	1	2
13	22	22	44
14	2	2	4
16	4	4	8
17	1	1	2
20	17	17	34
21	1	1	2
22	2	2	4
23	8	8	16
24	2	2	4
25	6	6	12
26	4	4	8
27	5	5	10
28	41	41	82
29	2	2	4
30	5	5	10
31	3	3	6
32	4	4	8
33	11	11	22
34	13	13	26
35	35	35	70
36	43	43	86
37	19	19	38
38	39	39	78
39	6	6	12
40	1	1	2
41	1	1	2

42	5	5	10
44	3	3	6
45	4	4	8
47	3	3	6
48	12	12	24
50	17	17	34
51	9	9	18
53	3	3	6
54	1	1	2
55	6	6	12
56	9	9	18
57	4	4	8
58	9	9	18
59	13	13	26
70	1	1	2
72	1	1	2
73	77	77	154
75	3	3	6
78	1	1	2
79	7	7	14
80	11	11	22
82	3	3	6
87	11	11	22
99	4	4	8
Total	518	518	1036

Following Kubick et al. (2016), each tax-related comment letter (Treatment) in the sample is matched to a non-tax-related comment letter (Control) using the propensity score matching (PSM) regression as specified by Equation (2). Employing a caliper of 0.30, requiring exact matching on industry and year, and using nearest-neighbour matching on all other covariates without replacement yields 518 pairs of Treatment and Control. Any matched pairs without common support are removed.

$$TAXCOMMLETT_{i,t} = \gamma_0 + \gamma_1 ETR_{i,t} + \gamma_2 CETR_{i,t} + \gamma_3 PBTD_{i,t} + \gamma_4 Foreign_{i,t} + \gamma_5 Volatility\_ETR_{i,t} + \gamma_k SOX408_{i,t} + \gamma_k Auditor_{i,t} + \gamma_k Governance_{i,t} + \gamma_k FirmCharacteristics_{i,t} + \gamma_k IndustryScrutiny_{i,t} + \varepsilon_{i,t} \quad (2)$$

The dependent variable *TAXCOMMLETT* is a dummy that equals 1 if the firm resolves a tax-related comment letter and 0 if the firm resolves a non-tax-related comment letter. The independent variables include proxies for tax avoidance and tax uncertainty (*ETR*, *CETR*, *PBTD*, *Volatility_ETR*), presence of foreign operations (*Foreign*), other determinants of SEC comment letters (*SOX408*, *Auditor*, *Governance*, *FirmCharacteristics*) and SEC attention on certain industries (*IndustryScrutiny*). Robust standard errors are used. All variables are defined in Appendix A Panel B. Panel A reports the covariate balance for the matched sample. The far right two columns report p-values from t-tests and rank sum tests for differences in means and medians, respectively. Panels B and C confirm that the sample firms are matched within year and industry (two-digit SIC).

TABLE 3
The Effect of Tax-Related Comment Letters on Tax Avoidance

Panel A: Descriptive Statistics

Variables	N	Mean	SD	P25	P50	P75
$Conform\_Tax_{it}$	5,926	0.006	0.025	-0.010	0.000	0.015
ETR_{it}	5,926	0.276	0.118	0.204	0.293	0.355
$CETR_{it}$	5,926	0.234	0.139	0.136	0.230	0.322
$PBTD_{it}$	5,666	0.023	0.043	0.002	0.015	0.035
TTA_{it}	5,926	0.033	0.031	0.011	0.024	0.044
ROA_{it}	5,926	0.115	0.082	0.059	0.095	0.149
ACC_{it}	5,926	0.012	0.057	-0.020	0.009	0.042
$SIZE_{it-1}$	5,926	7.319	1.942	6.112	7.399	8.601
FI_{it}	5,926	0.032	0.047	0.000	0.013	0.050
$EQINC_{it}$	5,926	0.304	0.460	0.000	0.000	1.000
$INTANG_{it}$	5,926	0.273	0.246	0.068	0.223	0.416
PPE_{it}	5,926	0.238	0.219	0.088	0.169	0.306
NOL_{it}	5,926	0.759	0.428	1.000	1.000	1.000
ΔNOL_{it}	5,926	-0.001	0.059	-0.005	0.000	0.004
MTB_{it-1}	5,926	3.383	3.477	1.701	2.613	4.168
LEV_{it}	5,926	0.205	0.215	0.012	0.166	0.303
FCF_{it}	5,926	0.085	0.090	0.038	0.077	0.126
$R\&D_{it}$	5,926	0.032	0.050	0.000	0.008	0.044
$SALESGR_{it}$	5,926	0.112	0.190	0.011	0.078	0.173
$FORSEG_{it}$	5,926	7.335	8.510	1.000	6.000	10.000

Panel B: Difference-in-Difference Regressions

	Conforming TA	Nonconforming TA			Total TA
Variables	$\boldsymbol{Conform\_Tax_{it}}$	$\boldsymbol{ETR_{it}}$	$\boldsymbol{CETR_{it}}$	$\boldsymbol{PBTD_{it}}$	$\boldsymbol{TTA_{it}}$
$TAXCLFIRM_i$	0.001**	-0.017***	0.000	0.004***	0.001
	(0.027)	(0.000)	(0.981)	(0.007)	(0.328)
$POST_{it}$	0.002***	0.006	0.021***	-0.003**	0.003***
	(0.005)	(0.191)	(0.000)	(0.026)	(0.000)
$TAXCLFIRM_i \times POST_{it}$	-0.002**	0.013**	-0.008	-0.004**	-0.001
	(0.018)	(0.018)	(0.250)	(0.031)	(0.208)
ROA_{it}	0.294***	0.308***	0.548***	0.110***	0.321***
	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)
ACC_{it}	-0.068***	-0.023	-0.819***	0.127***	-0.108***
	(0.000)	(0.636)	(0.000)	(0.000)	(0.000)
$SIZE_{it-1}$	-0.001***	-0.002*	-0.001	-0.001	-0.000
	(0.000)	(0.088)	(0.306)	(0.208)	(0.349)
FI_{it}	-0.030***	-0.356***	-0.215***	0.230***	-0.064***
	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)
$EQINC_{it}$	0.000	-0.006*	0.000	-0.001	0.000
	(0.875)	(0.071)	(0.971)	(0.483)	(0.832)
$INTANG_{it}$	0.008***	0.002	0.009	0.009***	0.008***
	(0.000)	(0.784)	(0.364)	(0.007)	(0.000)

PPE_{it}	0.013***	-0.016	-0.094***	0.013***	0.002
	(0.000)	(0.176)	(0.000)	(0.003)	(0.504)
NOL_{it}	0.003***	-0.017***	-0.056***	0.001	-0.008***
	(0.000)	(0.000)	(0.000)	(0.505)	(0.000)
ΔNOL_{it}	0.161***	0.093**	0.223***	-0.062***	0.056***
	(0.000)	(0.010)	(0.000)	(0.000)	(0.000)
MTB_{it-1}	0.000	0.000	-0.000	0.001**	0.000**
	(0.192)	(0.497)	(0.968)	(0.022)	(0.048)
LEV_{it}	0.001	-0.028***	-0.012	-0.001	0.002
	(0.366)	(0.006)	(0.255)	(0.794)	(0.442)
FCF_{it}	-0.042***	-0.136***	-0.720***	0.099***	-0.067***
	(0.000)	(0.002)	(0.000)	(0.000)	(0.000)
$R\&D_{it}$	0.011*	-0.304***	-0.333***	0.133***	-0.045***
	(0.086)	(0.000)	(0.000)	(0.000)	(0.000)
$SALESGR_{it}$	0.007***	-0.025**	-0.052***	0.013***	0.005**
	(0.000)	(0.018)	(0.000)	(0.002)	(0.027)
$FORSEG_{it}$	0.000	-0.000	0.002***	-0.000	0.000***
	(0.134)	(0.867)	(0.000)	(0.127)	(0.000)
BTD_{it}	-0.145***				
	(0.000)				
NEG_{it}	0.001				
	(0.193)				
$BTD_{it} \times NEG_{it}$	0.053***				
	(0.001)				
Intercept	-0.019***	0.461***	0.338***	-0.097***	0.016**
	(0.003)	(0.000)	(0.000)	(0.000)	(0.028)
Year Fixed Effects	YES	YES	YES	YES	YES
Industry Fixed Effects	YES	YES	YES	YES	YES
R^2	0.621	0.220	0.221	0.340	0.672
N	5,926	5,926	5,926	5,666	5,926

*, **, *** indicate statistical significance at the 10%, 5%, and 1% levels, respectively, using a two-tailed t-test. Panel A reports descriptive statistics for the variables used to test the effect of tax-related comment letter on nonconforming tax avoidance, conforming tax avoidance, and total tax avoidance. All continuous variables are winsorised at the 1 percent and 99 percent levels. Panel B reports difference-in-differences regressions as specified by Equation (3). Robust standard errors are used. Reported p-values are presented in round brackets.

$$Conform\_Tax_{i,t}/ETR_{i,t}/CETR_{i,t}/PBTD_{i,t}/TTA_{i,t} = \alpha_0 + \alpha_1 TAXCLFIRM_i + \alpha_2 POST_{i,t} + \alpha_3 TAXCLFIRM_i \times POST_{i,t} + \alpha_k Controls_k + \tau_t + \lambda_j + \varepsilon_{i,t} \quad (3)$$

The dependent variable is the measure of conforming tax avoidance (*Conform_Tax*), or one of the proxies for nonconforming tax avoidance (*ETR*, *CETR*, *PBTD*), or total tax avoidance (*TTA*). *TAXCLFIRM* is an indicator variable that equals 1 for tax-related comment letter firms and 0 for non-tax-related comment letter firms. *POST* is an indicator variable that equals 1 for fiscal years after the resolution of each firm's individual comment letter, and 0 otherwise. *TAXCLFIRM* × *POST* is the difference-in-differences estimator. Control variables follow Kubick et al. (2016). Year and industry fixed effects are included.

TABLE 4
Conforming Tax Avoidance and the Increase in Effective Tax Rates

	Large Increase in ETR	Small Increase in ETR
	(1)	(2)
Variables	$Conform\_Tax_{it}$	$Conform\_Tax_{it}$
$TAXCLFIRM_i$	0.001	0.002**
	(0.427)	(0.023)
$POST_{it}$	0.002**	0.002**
	(0.044)	(0.035)
$TAXCLFIRM_i \times POST_{it}$	-0.003**	-0.001
	(0.026)	(0.315)
ROA_{it}	0.284***	0.311***
	(0.000)	(0.000)
ACC_{it}	-0.073***	-0.069***
	(0.000)	(0.000)
$SIZE_{it-1}$	-0.001***	-0.000**
	(0.000)	(0.022)
FI_{it}	-0.029***	-0.031***
	(0.010)	(0.004)
$EQINC_{it}$	-0.001	0.001
	(0.322)	(0.137)
$INTANG_{it}$	0.010***	0.009***
	(0.000)	(0.000)
PPE_{it}	0.015***	0.012***
	(0.000)	(0.000)
NOL_{it}	0.003**	0.003***
	(0.012)	(0.002)
ΔNOL_{it}	0.168***	0.150***
	(0.000)	(0.000)
MTB_{it-1}	0.000	0.000
	(0.282)	(0.291)
LEV_{it}	0.001	0.002
	(0.615)	(0.263)
FCF_{it}	-0.034***	-0.060***
	(0.008)	(0.000)
$R\&D_{it}$	0.009	0.014*
	(0.372)	(0.098)
$SALESGR_{it}$	0.009***	0.004*
	(0.001)	(0.074)
$FORSEG_{it}$	0.000*	0.000
	(0.086)	(0.874)
BTD_{it}	-0.153***	-0.132***
	(0.000)	(0.000)
NEG_{it}	-0.000	0.002**
	(0.925)	(0.038)
$BTD_{it} \times NEG_{it}$	0.042**	0.071***
	(0.030)	(0.004)

Intercept	-0.015	-0.023***
	(0.115)	(0.000)
Year Fixed Effects	YES	YES
Industry Fixed Effects	YES	YES
R^2	0.608	0.655
N	2,837	3,089

*, **, *** indicate statistical significance at the 10%, 5%, and 1% levels, respectively, using a two-tailed t-test. This table presents the difference-in-differences regression results testing Equation (3) after splitting the propensity score matched sample into sub-samples using the change in effective tax rates from the event year t to t+1. Column (1) shows the results for firms with larger increase in effective tax rates and Column (2) shows the results for firms with smaller increase in effective tax rates.

TABLE 5
Conforming Tax Avoidance and SEC Tax-Related Comment Letters: The Influence of Capital Market Pressure

	StockIssue **Equals 1**	***StockIssue*** **Equals 0**	**Above Median** ***AnalystFollow***	**Below Median** ***AnalystFollow***	**Above Median** ***SALESGR***	**Below Median** ***SALESGR***	**Top 25%** **of *ACC***	**Bottom 25%** **of *ACC***
	(1)	**(2)**	**(3)**	**(4)**	**(5)**	**(6)**	**(7)**	**(8)**
Variables	$Conform\_Tax_{it}$	$Conform\_Tax_{it}$	$Conform\_Tax_{it}$	$Conform\_Tax_{it}$	$Conform\_Tax_{it}$	$Conform\_Tax_{it}$	$Conform\_Tax_{it}$	$Conform\_Tax_{it}$
$TAXCLFIRM_i$	0.001	0.002**	0.001	0.003***	0.001	0.002**	0.001	0.003**
	(0.682)	(0.018)	(0.524)	(0.005)	(0.382)	(0.015)	(0.498)	(0.013)
$POST_{it}$	-0.004	0.002***	0.000	0.003***	0.002	0.002**	0.003***	0.003*
	(0.235)	(0.001)	(0.643)	(0.002)	(0.109)	(0.010)	(0.009)	(0.058)
$TAXCLFIRM_i \times POST_{it}$	-0.002	-0.002**	-0.001	-0.002*	-0.002	-0.002**	-0.002	-0.005**
	(0.652)	(0.028)	(0.221)	(0.067)	(0.208)	(0.028)	(0.295)	(0.013)
ROA_{it}	0.269***	0.304***	0.294***	0.301***	0.297***	0.297***	0.265***	0.303***
	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)
ACC_{it}	-0.048*	-0.075***	-0.081***	-0.075***	-0.059***	-0.096***	-0.055***	-0.095***
	(0.070)	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)	(0.010)	(0.000)
$SIZE_{it-1}$	-0.002**	-0.001***	-0.000	-0.001***	-0.001***	-0.000*	-0.001**	-0.001
	(0.023)	(0.000)	(0.672)	(0.002)	(0.000)	(0.079)	(0.028)	(0.145)
FI_{it}	-0.030	-0.035***	-0.042***	-0.023**	-0.024**	-0.048***	-0.018	-0.015
	(0.333)	(0.000)	(0.000)	(0.039)	(0.031)	(0.000)	(0.285)	(0.267)
$EQINC_{it}$	0.001	-0.000	-0.000	0.000	0.001	-0.001*	-0.001	0.000
	(0.728)	(0.706)	(0.400)	(0.994)	(0.221)	(0.093)	(0.360)	(0.856)
$INTANG_{it}$	0.015***	0.006***	0.008***	0.010***	0.013***	0.001	0.006	0.011***
	(0.002)	(0.000)	(0.000)	(0.000)	(0.000)	(0.499)	(0.104)	(0.000)
PPE_{it}	0.019***	0.012***	0.014***	0.012***	0.016***	0.008***	0.017***	0.016***
	(0.002)	(0.000)	(0.000)	(0.000)	(0.000)	(0.008)	(0.000)	(0.003)
NOL_{it}	-0.000	0.003***	0.004***	0.002**	0.002*	0.005***	0.002	0.001
	(0.905)	(0.000)	(0.000)	(0.016)	(0.063)	(0.000)	(0.206)	(0.239)
ΔNOL_{it}	0.131***	0.166***	0.148***	0.161***	0.161***	0.163***	0.135***	0.171***
	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)
MTB_{it-1}	0.001	0.000	0.000	0.000	0.000	0.000	0.000	-0.000
	(0.192)	(0.522)	(0.216)	(0.498)	(0.279)	(0.383)	(0.161)	(0.583)
LEV_{it}	-0.000	0.003*	0.005**	0.001	0.002	-0.000	0.004	0.001
	(0.970)	(0.085)	(0.021)	(0.812)	(0.345)	(0.988)	(0.262)	(0.790)

FCF_{it}	-0.033	-0.048***	-0.046***	-0.049***	-0.035***	-0.063***	-0.035**	-0.048**
	(0.149)	(0.000)	(0.001)	(0.000)	(0.005)	(0.000)	(0.030)	(0.011)
$R\&D_{it}$	0.003	0.009	0.010	0.020**	0.012	0.006	0.009	0.008
	(0.875)	(0.151)	(0.276)	(0.030)	(0.180)	(0.430)	(0.528)	(0.541)
$SALESGR_{it}$	0.006	0.005**	0.003	0.009***	0.006**	0.006	0.009***	0.009***
	(0.211)	(0.012)	(0.217)	(0.000)	(0.016)	(0.183)	(0.006)	(0.007)
$FORSEG_{it}$	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000
	(0.505)	(0.182)	(0.491)	(0.732)	(0.231)	(0.348)	(0.347)	(0.269)
BTD_{it}	-0.129***	-0.148***	-0.129***	-0.150***	-0.142***	-0.152***	-0.125***	-0.166***
	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)
NEG_{it}	-0.001	0.001	0.002**	-0.001	0.001	0.000	-0.000	-0.001
	(0.610)	(0.249)	(0.036)	(0.319)	(0.321)	(0.807)	(0.749)	(0.507)
$BTD_{it}\times NEG_{it}$	0.071	0.041***	0.052*	0.049**	0.082***	0.025	0.057**	0.065**
	(0.214)	(0.008)	(0.055)	(0.011)	(0.000)	(0.187)	(0.046)	(0.036)
Intercept	0.018	-0.024***	-0.012	-0.035***	-0.020***	-0.020**	-0.017**	-0.032**
	(0.378)	(0.000)	(0.109)	(0.000)	(0.009)	(0.042)	(0.014)	(0.016)
Year Fixed Effects	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Industry Fixed Effects	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
R^2	0.595	0.637	0.633	0.632	0.633	0.619	0.528	0.691
N	527	5,399	2,860	2,762	2,963	2,963	1,481	1,482

*, **, *** indicate statistical significance at the 10%, 5%, and 1% levels, respectively, using a two-tailed t-test.

This table presents the difference-in-differences regression results testing Equation (3) after splitting the propensity score matched sample into different sub-samples using four measures of capital market pressure: *StockIssue*, *AnalystFollow*, *SALESGR*, and *ACC*. *StockIssue* is an indicator variable that equals 1 if the firm's shares outstanding in year t is greater than 110 percent of shares outstanding in year t-1. Column (1) shows the results for firms that have stock issuances (*StockIssue*=1) and Column (2) shows the results for firms that have no stock issuances (*StockIssue*=0). *AnalystFollow* is the number of analysts providing after-tax earnings per share forecast in year t, obtained from IBES. Column (3) shows the results for firms that have above median number of analysts following and Column (4) shows the results for firms that have below median number of analysts following. *SALESGR* is sales at the end of year t less sales at the beginning of year t, divided by sales at the beginning of year t. Column (5) shows the results for firms that have above median level of sales growth and Column (6) shows the results for firms that have below median level of sales growth. *ACC* is performance matched discretionary accruals, calculated following the method in Frank et al. (2009). Column (7) shows the results for firms in the top quartile of discretionary accruals and Column (8) shows the results for firms in the bottom quartile of discretionary accruals. High capital market pressure is represented by *StockIssue* equalling 1, above median *AnalystFollow*, above median *SALESGR*, and top 25% of *ACC*. Low capital market pressure is represented by *StockIssue* equalling 0, below median *AnalystFollow*, below median *SALESGR*, and bottom 25% of *ACC*.

TABLE 6
Conforming Tax Avoidance and SEC Tax-Related Comment Letters: The Influence of Bank Loan Covenants

	FinCovenant **Equals 1**	***FinCovenant*** **Equals 0**	***EarCovenant*** **Equals 1**	***EarCovenant*** **Equals 0**
	(1)	**(2)**	**(3)**	**(4)**
Variables	$Conform\_Tax_{it}$	$Conform\_Tax_{it}$	$Conform\_Tax_{it}$	$Conform\_Tax_{it}$
$TAXCLFIRM_i$	-0.001	0.002***	-0.008***	0.002***
	(0.327)	(0.002)	(0.002)	(0.001)
$POST_{it}$	-0.001	0.002***	-0.002	0.002***
	(0.668)	(0.001)	(0.353)	(0.001)
$TAXCLFIRM_i \times POST_{it}$	0.001	-0.003***	0.005*	-0.002***
	(0.618)	(0.007)	(0.097)	(0.008)
ROA_{it}	0.304***	0.297***	0.261***	0.298***
	(0.000)	(0.000)	(0.000)	(0.000)
ACC_{it}	-0.081***	-0.073***	-0.082**	-0.072***
	(0.000)	(0.000)	(0.015)	(0.000)
$SIZE_{it-1}$	-0.000	-0.001***	-0.000	-0.001***
	(0.176)	(0.000)	(0.643)	(0.000)
FI_{it}	-0.022	-0.034***	0.008	-0.030***
	(0.136)	(0.000)	(0.697)	(0.000)
$EQINC_{it}$	-0.000	-0.000	-0.000	-0.000
	(0.658)	(0.898)	(0.877)	(0.612)
$INTANG_{it}$	0.007**	0.009***	0.003	0.009***
	(0.023)	(0.000)	(0.471)	(0.000)
PPE_{it}	0.015***	0.013***	0.012*	0.013***
	(0.000)	(0.000)	(0.071)	(0.000)
NOL_{it}	0.004***	0.003***	0.004	0.003***
	(0.002)	(0.000)	(0.199)	(0.000)
ΔNOL_{it}	0.160***	0.154***	0.167***	0.161***
	(0.000)	(0.000)	(0.000)	(0.000)
MTB_{it-1}	-0.000	0.000	-0.000	0.000
	(0.677)	(0.165)	(0.679)	(0.131)
LEV_{it}	0.008**	0.001	0.004	0.001
	(0.028)	(0.665)	(0.441)	(0.673)
FCF_{it}	-0.039**	-0.050***	-0.041	-0.047***
	(0.023)	(0.000)	(0.174)	(0.000)
$R\&D_{it}$	-0.004	0.012*	0.011	0.011*
	(0.716)	(0.090)	(0.602)	(0.093)
$SALESGR_{it}$	0.000	0.008***	-0.003	0.008***
	(0.991)	(0.000)	(0.584)	(0.000)
$FORSEG_{it}$	0.000	0.000	-0.000	0.000
	(0.477)	(0.382)	(0.500)	(0.452)
BTD_{it}	-0.137***	-0.139***	-0.155***	-0.144***
	(0.000)	(0.000)	(0.000)	(0.000)
NEG_{it}	0.001	0.001	0.004	0.001
	(0.565)	(0.233)	(0.107)	(0.380)

$BTD_{it} \times NEG_{it}$	-0.004	0.058***	0.071	0.052***
	(0.889)	(0.001)	(0.162)	(0.001)
Intercept	-0.009	-0.028***	0.002	-0.030***
	(0.359)	(0.000)	(0.900)	(0.000)
Year Fixed Effects	Yes	Yes	Yes	Yes
Industry Fixed Effects	Yes	Yes	Yes	Yes
R^2	0.701	0.614	0.685	0.627
N	1,320	4,606	542	5,384

*, **, *** indicate statistical significance at the 10%, 5%, and 1% levels, respectively, using a two-tailed t-test. Panel A presents the difference-in-differences regression results testing Equation (3) after splitting the propensity score matched sample into sub-samples depending on whether a firm is subject to a loan contract with covenants. *FinCovenant* is an indicator variable that equals 1 if the loan contract has financial covenants, obtained from DealScan. *EarCovenant* is an indicator variable that equals 1 if the loan contract has earnings-related covenants, i.e. those including "Interest Coverage Ratio" and "Fixed Charge Coverage Ratio". Column (1) shows the results for firms that are subject to financial covenants (*FinCovenant*=1) and Column (2) shows the results for firms that are subject to no financial covenants (*FinCovenant*=0). Column (3) shows the results for firms that are subject to earnings-related covenants (*EarCovenant*=1) and Column (4) shows the results for firms that are subject to no earnings-related covenants (*EarCovenant*=0).

TABLE 7
Conforming Tax Avoidance and SEC Tax-Related Comment Letters: The Influence of Equity Incentives

Panel A: Cross-Sectional Tests

	High *CEOVega*	Low *CEOVega*	High *CEODelta*	Low *CEODelta*
	(1)	(2)	(3)	(4)
Variables	$Conform\_Tax_{it}$	$Conform\_Tax_{it}$	$Conform\_Tax_{it}$	$Conform\_Tax_{it}$
$TAXCLFIRM_i$	0.001	0.003**	0.001	0.002*
	(0.221)	(0.028)	(0.352)	(0.073)
$POST_{it}$	0.001	0.001	0.002	0.001
	(0.300)	(0.214)	(0.155)	(0.219)
$TAXCLFIRM_i \times POST_{it}$	-0.003**	-0.002	-0.002	-0.003**
	(0.050)	(0.148)	(0.153)	(0.044)
ROA_{it}	0.346***	0.329***	0.341***	0.331***
	(0.000)	(0.000)	(0.000)	(0.000)
ACC_{it}	-0.150***	-0.072***	-0.139***	-0.085***
	(0.000)	(0.000)	(0.000)	(0.000)
$SIZE_{it-1}$	-0.001**	-0.001**	-0.001**	-0.001**
	(0.013)	(0.031)	(0.014)	(0.019)
FI_{it}	-0.025*	-0.043***	-0.035**	-0.027**
	(0.057)	(0.001)	(0.031)	(0.024)
$EQINC_{it}$	0.001	-0.000	0.001	-0.001
	(0.495)	(0.580)	(0.376)	(0.450)
$INTANG_{it}$	0.007***	0.012***	0.009***	0.011***
	(0.004)	(0.000)	(0.001)	(0.000)
PPE_{it}	0.010**	0.013***	0.009**	0.013***
	(0.010)	(0.001)	(0.026)	(0.000)
NOL_{it}	0.005***	0.003**	0.007***	0.001
	(0.000)	(0.030)	(0.000)	(0.334)
ΔNOL_{it}	0.131***	0.164***	0.130***	0.166***
	(0.000)	(0.000)	(0.000)	(0.000)
MTB_{it-1}	0.000	-0.000	-0.000	0.000
	(0.772)	(0.638)	(0.646)	(0.694)
LEV_{it}	0.009***	0.004	0.009**	0.003
	(0.006)	(0.130)	(0.013)	(0.165)
FCF_{it}	-0.122***	-0.059***	-0.111***	-0.070***
	(0.000)	(0.000)	(0.000)	(0.000)
$R\&D_{it}$	0.020*	-0.003	0.029**	-0.007
	(0.066)	(0.759)	(0.025)	(0.483)
$SALESGR_{it}$	0.010***	0.006**	0.011***	0.007***
	(0.001)	(0.016)	(0.004)	(0.007)
$FORSEG_{it}$	0.000	0.000	-0.000	0.000**
	(0.596)	(0.133)	(0.282)	(0.011)
BTD_{it}	-0.113***	-0.153***	-0.116***	-0.152***
	(0.000)	(0.000)	(0.000)	(0.000)
NEG_{it}	0.002*	0.002	0.003*	0.001
	(0.081)	(0.213)	(0.052)	(0.319)

$BTD_{it}\times NEG_{it}$	0.026	0.071**	0.064**	0.039
	(0.344)	(0.026)	(0.047)	(0.155)
Intercept	-0.036***	-0.012	-0.036***	-0.014*
	(0.000)	(0.172)	(0.000)	(0.080)
Year Fixed Effects	Yes	Yes	Yes	Yes
Industry Fixed Effects	Yes	Yes	Yes	Yes
R^2	0.680	0.673	0.683	0.671
N	1,779	1,860	1,518	2,104

Panel B: Difference-in-Difference Regressions

Variables	$\boldsymbol{CEOVega_{it}}$	$\boldsymbol{CEODelta_{it}}$
$TAXCLFIRM_i$	-0.094	-0.110**
	(0.198)	(0.041)
$POST_{it}$	-0.269***	-0.015
	(0.009)	(0.824)
$TAXCLFIRM_i\times POST_{it}$	0.273**	0.126
	(0.040)	(0.120)
Control Variables	Included	Included
Year Fixed Effects	Yes	Yes
Industry Fixed Effects	Yes	Yes
R^2	0.325	0.374
N	2,902	2,902

*, **, *** indicate statistical significance at the 10%, 5%, and 1% levels, respectively, using a two-tailed t-test. Panel A presents the difference-in-differences regression results testing Equation (3) after splitting the propensity score matched sample into sub-samples using two measures of equity incentives: the CEO's wealth sensitivity to stock return volatility (*CEOVega*) and sensitivity to stock price (*CEODelta*). *CEOVega* is the natural log of one plus CEO wealth sensitivity to stock price volatility, calculated as the change in the value of a CEO's stock option portfolio for a given change in stock return volatility, following Coles et al. (2006). Column (1) shows the results for firms that have above average level of vega and Column (2) shows the results for firms that have below average level of vega. *CEODelta* is the natural log of one plus CEO wealth sensitivity to stock price, calculated as the change in the CEO's wealth for a given change in stock price, following Coles et al. (2006). Column (3) shows the results for firms that have above average level of delta and Column (4) shows the results for firms that have below average level of delta.

Panel B reports difference-in-differences regressions to examine the effects of tax-related comment letters on CEO's wealth sensitivity to stock return volatility (*CEOVega*) and stock price (*CEODelta*). Control variables are the same as those included in Equation (3). Year and industry fixed effects are included. Robust standard errors are used. Reported p-values are presented in round brackets.

TABLE 8
Conforming Tax Avoidance and SEC Tax-Related Comment Letters: The Influence of Investor and Board Monitoring

	Above Median *InstPerc*	Below Median *InstPerc*	Above Median *BoardIndPct*	Below Median *BoardIndPct*	Above Median *BoardMtgs*	Below Median *BoardMtgs*	Top 25% of PC	Bottom 25% of PC
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Variables	$Conform\_Tax_{it}$	$Conform\_Tax_{it}$	$Conform\_Tax_{it}$	$Conform\_Tax_{it}$	$Conform\_Tax_{it}$	$Conform\_Tax_{it}$	$Conform\_Tax_{it}$	$Conform\_Tax_{it}$
$TAXCLFIRM_i$	0.002*	0.000	0.003**	0.001	0.002**	-0.001	0.004**	-0.001
	(0.054)	(0.900)	(0.011)	(0.323)	(0.031)	(0.511)	(0.030)	(0.694)
$POST_{it}$	0.003***	0.001	0.002*	0.001	0.001	0.001	0.002	0.001
	(0.006)	(0.568)	(0.051)	(0.261)	(0.317)	(0.213)	(0.122)	(0.433)
$TAXCLFIRM_i \times POST_{it}$	-0.003**	-0.001	-0.003***	-0.001	-0.002*	-0.001	-0.004*	-0.002
	(0.020)	(0.643)	(0.010)	(0.516)	(0.069)	(0.677)	(0.052)	(0.293)
ROA_{it}	0.324***	0.308***	0.327***	0.298***	0.310***	0.308***	0.330***	0.312***
	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)
ACC_{it}	-0.085***	-0.088***	-0.088***	-0.060***	-0.091***	-0.082***	-0.091***	-0.040
	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)	(0.176)
$SIZE_{it-1}$	-0.001***	-0.001**	-0.001***	-0.000**	-0.001***	-0.001***	-0.001**	-0.000
	(0.000)	(0.039)	(0.000)	(0.046)	(0.002)	(0.000)	(0.049)	(0.255)
FI_{it}	-0.044***	-0.026**	-0.054***	-0.026**	-0.030**	-0.040***	-0.051***	-0.026*
	(0.000)	(0.042)	(0.000)	(0.015)	(0.012)	(0.001)	(0.007)	(0.093)
$EQINC_{it}$	-0.000	0.002**	0.001	0.000	-0.001	0.001*	0.002*	-0.001
	(0.734)	(0.034)	(0.355)	(0.791)	(0.333)	(0.097)	(0.063)	(0.515)
$INTANG_{it}$	0.010***	0.009***	0.009***	0.010***	0.007***	0.010***	0.011***	0.012***
	(0.000)	(0.000)	(0.000)	(0.000)	(0.001)	(0.000)	(0.001)	(0.000)
PPE_{it}	0.007**	0.013***	0.014***	0.014***	0.015***	0.014***	0.008**	0.012**
	(0.034)	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)	(0.046)	(0.034)
NOL_{it}	0.004***	0.001	0.003***	0.003***	0.008***	0.003***	0.003*	0.002
	(0.000)	(0.321)	(0.000)	(0.001)	(0.000)	(0.009)	(0.065)	(0.261)
ΔNOL_{it}	0.149***	0.166***	0.163***	0.153***	0.131***	0.161***	0.156***	0.142***
	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)
MTB_{it-1}	0.000	0.000	0.000	0.000	-0.000	0.000	-0.000	-0.000
	(0.965)	(0.482)	(0.944)	(0.246)	(0.833)	(0.634)	(0.556)	(0.784)
LEV_{it}	0.004*	0.001	0.002	0.003	0.007***	0.001	0.004	0.006
	(0.070)	(0.813)	(0.270)	(0.265)	(0.004)	(0.775)	(0.342)	(0.186)

FCF_{it}	-0.064***	-0.056***	-0.058***	-0.053***	-0.062***	-0.049***	-0.073***	-0.055**
	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)	(0.002)	(0.001)	(0.049)
$R\&D_{it}$	0.013	-0.003	0.015	0.011	0.016	0.008	0.016	0.012
	(0.183)	(0.803)	(0.104)	(0.261)	(0.118)	(0.332)	(0.291)	(0.452)
$SALESGR_{it}$	0.006**	0.007**	0.006**	0.005*	0.003	0.006**	-0.001	0.005
	(0.029)	(0.025)	(0.011)	(0.061)	(0.342)	(0.016)	(0.828)	(0.191)
$FORSEG_{it}$	0.000***	-0.000	0.000	0.000**	0.000	0.000*	0.000	0.000**
	(0.000)	(0.437)	(0.561)	(0.031)	(0.179)	(0.050)	(0.535)	(0.026)
BTD_{it}	-0.138***	-0.140***	-0.145***	-0.135***	-0.120***	-0.150***	-0.128***	-0.154***
	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)
NEG_{it}	0.001	0.003**	0.001	0.001	0.002*	0.001	0.003*	-0.001
	(0.187)	(0.034)	(0.499)	(0.254)	(0.064)	(0.494)	(0.073)	(0.568)
$BTD_{it}\times NEG_{it}$	0.063**	0.044	0.023	0.062**	0.041*	0.050*	0.027	0.078
	(0.011)	(0.121)	(0.240)	(0.024)	(0.073)	(0.054)	(0.365)	(0.119)
Intercept	-0.011	-0.037*	-0.033***	-0.021**	-0.016**	-0.035**	-0.070***	-0.027*
	(0.142)	(0.055)	(0.000)	(0.012)	(0.020)	(0.025)	(0.000)	(0.070)
Year Fixed Effects	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Industry Fixed Effects	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
R^2	0.643	0.659	0.660	0.623	0.612	0.678	0.679	0.689
N	2,609	1,915	2,801	2,624	2,074	2,481	1,004	1,005

*, **, *** indicate statistical significance at the 10%, 5%, and 1% levels, respectively, using a two-tailed t-test.

This table presents the difference-in-differences regression results testing Equation (3) after splitting the propensity score matched sample into different sub-samples using four measures of investor and board monitoring: *InstPercNonTrans*, *BoardIndPct*, *BoardMtgs* and *PC*. *InstPercNonTrans* is the percentage of nontransient institutional shareholders, calculated following Bushee (1998). Column (1) shows the results for firms that have above median percentage of nontransient institutional shareholders and Column (2) shows the results for firms that have below median percentage of nontransient institutional shareholders. *BoardIndPct* is the percentage of independent directors on the corporate board. Column (3) shows the results for firms that have above median percentage of independent board members and Column (4) shows the results for firms that have below median percentage of independent board members. *BoardMtgs* is the number of board meetings. Column (5) shows the results for firms that have above median number of board meetings and Column (6) shows the results for firms that have below median number of board meetings. These three measures of investor and board monitoring are used to conduct a principal component analysis and construct a monitoring index (*PC*) for each firm. Column (7) shows the results for firms that are in the top 25% of the monitoring index and Column (8) shows the results for firms are in the bottom 25% of the monitoring index. High monitoring is represented by above median *InstPercNonTrans*, *BoardIndPct*, *BoardMtgs*, and top 25% of *PC*. Low monitoring is represented by below median *InstPercNonTrans*, *BoardIndPct*, *BoardMtgs*, and bottom 25% of *PC*.

TABLE 9
Conforming Tax Avoidance and Real Earnings Management

Panel A: The Effect of Tax-Related Comment Letters on Earnings Management

	AEM	REM		
Variables	ACC_{it}	$DISCR\_CFO_{it}$	$DISCR\_EXP_{it}$	$DISCR\_PROD_{it}$
$TAXCLFIRM_i$	0.000	0.010***	0.012	-0.041***
	(0.984)	(0.004)	(0.274)	(0.000)
$POST_{it}$	0.002	-0.001	0.007	-0.014
	(0.463)	(0.624)	(0.494)	(0.121)
$TAXCLFIRM_i \times POST_{it}$	-0.002	-0.010**	-0.012	0.037***
	(0.526)	(0.010)	(0.420)	(0.001)
ROA_{it}	0.474***	0.517***	-0.059	-0.483***
	(0.000)	(0.000)	(0.554)	(0.000)
ACC_{it}		-0.536***	-0.351*	0.262**
		(0.000)	(0.077)	(0.012)
$SIZE_{it-1}$	-0.005***	0.007***	-0.033***	0.014***
	(0.000)	(0.000)	(0.000)	(0.000)
FI_{it}	0.061**	0.073**	0.201	-0.141
	(0.042)	(0.023)	(0.175)	(0.222)
$EQINC_{it}$	0.006***	-0.008***	-0.044***	0.041***
	(0.009)	(0.005)	(0.000)	(0.000)
$INTANG_{it}$	-0.021***	0.020**	-0.103***	-0.049**
	(0.005)	(0.020)	(0.000)	(0.012)
PPE_{it}	-0.028**	0.095***	-0.047	-0.113***
	(0.015)	(0.000)	(0.179)	(0.000)
NOL_{it}	0.006***	0.000	0.040***	-0.020**
	(0.009)	(0.903)	(0.000)	(0.018)
ΔNOL_{it}	-0.004	-0.128***	0.278***	-0.123***
	(0.848)	(0.000)	(0.000)	(0.007)
MTB_{it-1}	-0.001	-0.001	0.014***	-0.006***
	(0.188)	(0.101)	(0.000)	(0.000)
LEV_{it}	0.028**	0.016	-0.018	-0.043**
	(0.012)	(0.302)	(0.435)	(0.025)
FCF_{it}	-0.685***		0.025	-0.365***
	(0.000)		(0.888)	(0.000)
$R\&D_{it}$	-0.041	0.066*		-1.078***
	(0.228)	(0.057)		(0.000)
$SALESGR_{it}$	-0.001	0.069***	0.254***	0.051**
	(0.889)	(0.000)	(0.000)	(0.029)
$FORSEG_{it}$	0.000	-0.000*	0.002***	-0.001**
	(0.193)	(0.068)	(0.000)	(0.022)
Intercept	0.013	0.023	-0.168***	0.085**
	(0.373)	(0.248)	(0.000)	(0.046)
Year Fixed Effects	YES	YES	YES	YES
Industry Fixed Effects	YES	YES	YES	YES
R^2	0.446	0.660	0.397	0.511
N	6,657	6,657	6,657	6,657

Panel B: Including REM Variables in Equation (3)

	(1)	(2)
Variables	$Conform\_Tax_{it}$	$Conform\_Tax_{it}$
$TAXCLFIRM_i$	0.0019**	0.0019**
	(0.013)	(0.012)
$POST_{it}$	0.0023***	0.0022***
	(0.002)	(0.004)
$TAXCLFIRM_i \times POST_{it}$	-0.0025**	-0.0021**
	(0.011)	(0.028)
$DISCR\_CFO_{it}$		-0.0492***
		(0.000)
$DISCR\_EXP_{it}$		-0.0025
		(0.557)
$DISCR\_PROD_{it}$		-0.0094**
		(0.025)
Control Variables	Included	Included
Year Fixed Effects	YES	YES
Industry Fixed Effects	YES	YES
R^2	0.596	0.606
N	4,430	4,430

*, **, *** indicate statistical significance at the 10%, 5%, and 1% levels, respectively, using a two-tailed t-test. Panel A reports difference-in-differences regressions to examine the effects of tax-related comment letters on accrual earnings management (AEM) and real earnings management (REM).

$$ACC_{i,t}/DISCR\_CFO_{i,t}/DISCR\_EXP_{i,t}/DISCR\_PROD_{i,t} = \alpha_0 + \alpha_1 TAXCLFIRM_i + \alpha_2 POST_{i,t} + \alpha_3 TAXCLFIRM_i \times POST_{i,t} + \alpha_k Controls_k + \tau_t + \lambda_j + \varepsilon_{i,t} \quad (4)$$

The dependent variable is the AEM proxy (*ACC*), or one of the REM proxies (*DISCR_CFO*, *DISCR_EXP*, *DISCR_PROD*). *TAXCLFIRM* is an indicator variable that equals 1 for tax-related comment letter firms and 0 for non-tax-related comment letter firms. *POST* is an indicator variable that equals 1 for fiscal years after the resolution of each firm's individual comment letter, and 0 otherwise. *TAXCLFIRM* × *POST* is the difference-in-differences estimator. Control variables are the same as those included in Equation (3). Year and industry fixed effects are included. Robust standard errors are used. Reported p-values are presented in round brackets. Panel B presents the results from re-estimating Equation (3) using the new sample that have non-missing data for the REM variables. Column (1) shows the results without the REM variables and Column (2) shows the results after including the REM variables in Equation (3).

APPENDIX A
Variable Definitions

Panel A: Variable Definitions for Equation (1)

$TTA_{i,t}$	Cash taxes paid (CTP), scaled by lagged total assets (AT).
$BTD_{i,t}$	The total book-tax differences, calculated as the firm's book income less taxable income scaled by lagged total assets (AT). Book income is pre-tax income (PI) in year t. Taxable income is calculated by summing current federal tax expense (TXFED) and current foreign tax expense (TXFO) and dividing by the statutory tax rate (STR) and then subtracting the change in net operating loss carryforwards (TLCF) in year t. If current federal tax expense is missing, total current tax expense is calculated by subtracting deferred taxes (TXDI), state income taxes (TXS), and other income taxes (TXO) from total income taxes (TXT) in year t. The statutory tax rate is 0.35 for 2004-2017 and 0.21 for 2018-2020.
$NEG_{i,t}$	An indicator variable that equals 1 if the firm's total book-tax differences (BTD) are less than zero, and 0 otherwise.
$NOL_{i,t-1}$	An indicator variable that equals 1 if the firm has any tax loss carryforward (TLCF) available at t-1, and 0 otherwise.
$\Delta NOL_{i,t-1}$	The change in tax loss carryforward (TLCF) from t-2 to t-1, scaled by lagged total assets (AT); when missing, reset to 0.
$Conform\_Tax_{i,t}$	Conforming tax avoidance in year t, per Badertscher et al. (2019), calculated as the residual (ε) from Equation (1), which is estimated using the following OLS regression by three-digit NAICS code and fiscal year combinations, requiring at least 10 observations for each combination: $TTA_{i,t} = \beta_0 + \beta_1 BTD_{i,t} + \beta_2 NEG_{i,t} + \beta_3 BTD_{i,t} \times NEG_{i,t} + \beta_4 NOL_{i,t-1} + \beta_5 \Delta NOL_{i,t-1} + \varepsilon_{it}$ where *TTA* is the ratio of cash taxes paid (CTP) to lagged total assets (AT); *BTD* is the total book-tax differences; *NEG* is an indicator variable equalling 1 for observations with negative book-tax differences and 0 otherwise; *BTD* × *NEG* is the interaction of *BTD* and *NEG*; *NOL* and Δ*NOL* capture the level of and change in tax loss carryforwards (TLCF). *Conform_Tax* is decreasing in tax avoidance.

Panel B: Variable Definitions for Equation (2) in addition to those in (1)

$TAXCOMMLETT_{i,t}$	An indicator variable that equals 1 if a firm received a tax-related SEC comment letter, and 0 if the firm receives a non-tax-related SEC comment letter.
$ETR_{i,t}$	The GAAP effective tax rate, defined as income tax expense (TXT) divided by pre-tax income (PI) before special items (SPI).
$CETR_{i,t}$	The cash effective tax rate, defined as cash tax paid (TXPD) divided by pre-tax income (PI) before special items (SPI).
$PBTD_{i,t}$	The permanent book-tax difference, defined as pre-tax income less minority interest in earnings less estimated taxable income less deferred taxes (PI−MII−(TXFED+TXFO)/STR−TXDI/STR), scaled by lagged total assets (AT). STR equals 0.35 for 2004-2017 and 0.21 for 2018-2020.

$Foreign_{i,t}$	An indicator variable that equals 1 if the firm reports positive foreign income (PIFO), and 0 otherwise.
$Volatility\_ETR_{i,t}$	The volatility of ETR, calculated as standard deviation of GAAP ETRs in years t-1, t-2, t-3, t-4, and t-5.
$M\_Weak_{i,t}$	An indicator variable that equals 1 if the firm reports a material weakness under SOX302 or SOX404 (available in the Audit Analytics database) in year t-1, t-2 or t-3, and 0 otherwise.
$Restate_{i,t}$	An indicator variable that equals 1 if the firm has a restatement (available in the Audit Analytics database) in year t-1, t-2 or t-3, and 0 otherwise.
$HighVolatility_{i,t}$	An indicator variable that equal 1 if the volatility of monthly stock returns (CRSP (RET−VWRETD)) is in the highest quartile for that year, and 0 otherwise.
$InMarketCap_{i,t}$	Natural logarithm of market value of equity (PRCC_F*CSHO).
$CompanyAge_{i,t}$	The number of years a firm has reported total assets (AT) in COMPUSTAT database.
$Loss_{i,t}$	An indicator variable that equals 1 if the firm reports a loss (IB<0) in year t-1, t-2 or t-3, and 0 otherwise.
$BankruptcyRank_{i,t}$	The decile rank of the Altman Z-score, where Z-score is calculated as 1.2 × ((ACT − LCT) / AT) + 1.4 × (RE / AT) + 0.6 × (PRCC_F × CSHO) + 1.0 × (SALE / AT).
$RevtGrowth_{i,t}$	The mean sales growth (REVT in year t/REVT in year t-1) over years t-1, t-2, and t-3.
$Segments_{i,t}$	The number of reported operating segments (available in the COMPUSTAT Segments file).
$M\&A_{i,t}$	An indicator variable that equals 1 if a firm reports acquisitions (AQP) in year t-1, t-2 or t-3, and 0 otherwise.
$Restructuring_{i,t}$	An indicator variable that equals 1 if a firm reports restructuring (RCP) in year t-1, t-2 or t-3, and 0 otherwise.
$ExtFinancing_{i,t+1}$	Equity and debt financing ((SSTK + PRSTKC − DV) + (DLTIS – DLTR − DLCCH)), scaled by total assets (AT).
$Litigation_{i,t}$	An indicator variable that equals 1 if a firm is in a highly litigious industry (SIC 2833-2836, 3570-3577, 3600-3674, 5200-5961, 7370-7374), and 0 otherwise, following Francis, Philbrick, and Schipper (1994).
$Big4_{i,t}$	An indicator variable that equals 1 if a firm has a Big 4 auditor (AU = 4, 5, 6, 7), and 0 otherwise.
$SecondTier_{i,t}$	An indicator variable that equals 1 if a firm has a second-tier auditor (AU = 11, 17, 20, 21) , and 0 otherwise.
$AudTenure_{i,t}$	The number of consecutive years that the auditor (AU) has audited the firm.
$AuditorResigned_{i,t}$	An indicator variable that equals 1 if the auditor resigned (available in the Audit Analytics database) in year t-1, t-2 or t-3, and 0 otherwise.
$AuditorDismissed_{i,t}$	An indicator variable that equals 1 if the auditor was dismissed (available in the Audit Analytics database) year t-1, t-2 or t-3, and 0 otherwise.
$IndustryScrutiny_{i,t}$	The number of tax-related SEC comment letters issued by two-digit SIC.

$InstPercNonTrans_{i,t}$	The percentage of nontransient institutional investors (available in the TR 13F database), following Bushee (1998).
$CEO\_Chair_{i,t}$	An indicator variable that equals 1 if the CEO is Chair of the Board (available in the Execucomp database), and 0 otherwise.
$CFO\_BOD_{i,t}$	An indicator variable that equals 1 if CFO is on the Board of Directors (available in the Execucomp database), and 0 otherwise.
$BoardIndPct_{i,t}$	The percentage of independent directors on the Board (available in the BoardEx database).
$BoardMtgs_{i,t}$	The number of board meetings (available in the ISS database).
$CFO\_Tenure_{i,t}$	Tenure in years of CFO (available in the Execucomp database).
$CEO\_Tenure_{i,t}$	Tenure in years of CEO (available in the Execucomp database).
Panel C: Variable Definitions for Equations (3) in addition to those in (1)-(2)	
$TAXCLFIRM_i$	An indicator variable that equals 1 if a firm resolved a tax-related SEC comment letter at any point during 2004-2020, and 0 for the control firms that resolved a non-tax-related SEC comment letter.
$POST_{i,t}$	An indicator variable that equals 1 for years after the resolution of each firm's comment letter conversation.
$ROA_{i,t}$	Pre-tax income (PI), scaled by lagged total assets (AT).
$ACC_{i,t}$	Performance matched pre-tax discretionary accruals, following Frank, Lynch, and Rego (2009).
$SIZE_{i,t-1}$	Lagged market value of equity (PRCC_F*CSHO).
$FI_{i,t}$	Pre-tax foreign income (PIFO), scaled by lagged total assets (AT); when missing, reset to 0.
$EQINC_{i,t}$	An indicator variable that equals 1 if equity income in earnings (ESUB) is positive, and 0 otherwise.
$INTAN_{i,t}$	Intangible assets (INTAN), scaled by lagged total assets (AT).
$PPE_{i,t}$	Net property, plant, and equipment (PPENT), scaled by lagged total assets (AT).
$NOL_{i,t}$	An indicator variable that equals 1 if the firm reports a positive tax loss carryforward (TLCF), and 0 otherwise.
$\Delta NOL_{i,t}$	The change in tax loss carryforward (TLCF) from t-1 to t, scaled by lagged total assets (AT); when missing, reset to 0.
$MTB_{i,t-1}$	Lagged market-to-book ratio, calculated as the market value of equity (PRCC_F*CSHO) scaled by the book value of equity (CEQ).
$LEV_{i,t}$	The sum of long-term debt (DLTT) and long-term debt in current liabilities (DLC), scaled by lagged total assets (AT).
$FCF_{i,t}$	Free cash flow (OANCF−CAPX), scaled by lagged total assets (AT).
$R\&D_{i,t}$	Research and development expense (XRD), scaled by lagged total assets (AT); when missing, reset to 0.
$SALESGR_{i,t}$	The annual percentage change in net sales (SALE) from t-1 to t.
$FORSEG_{i,t}$	The number of foreign operating segments (available in the COMPUSTAT Segments file).
Panel D: Variable Definitions for Equations (4) in addition to those in (1)-(3)	
$DISCR\_CFO_{i,t}$	Discretionary cash flow from operations in year t, per Roychowdhury (2006), calculated as the residual (ε) from the following regression estimated by three-digit SIC code and fiscal

year combinations, requiring at least 10 observations for each combination:

$$\frac{CFO_{i,t}}{TA_{i,t-1}} = \varphi_0 + \varphi_1 \frac{1}{TA_{1,t-1}} + \varphi_2 \frac{SALE_{i,t}}{TA_{i,t-1}} + \varphi_3 \frac{\Delta SALE_{i,t}}{TA_{i,t-1}} + \varepsilon_{i,t}$$

where *CFO* is cash flow from operations (OANCF); *TA* is total assets (AT); *SALE* is sales (SALE); Δ*SALE* is change in sales.

$DISCR\_EXP_{i,t}$ Discretionary expenses in year t, per Roychowdhury (2006), calculated as the residual (ε) from the following regression estimated by three-digit SIC code and fiscal year combinations, requiring at least 10 observations for each combination:

$$\frac{DISEXP_{i,t}}{TA_{i,t-1}} = \varphi_0 + \varphi_1 \frac{1}{TA_{1,t-1}} + \varphi_2 \frac{SALE_{i,t-1}}{TA_{i,t-1}} + \varepsilon_{i,t}$$

where *DISEXP* is the sum of research and development expense (XRD), advertising expense (XAD), and selling, general, and administrative expense (XSGA); *TA* is total assets (AT); *SALE* is sales (SALE); Δ*SALE* is change in sales.

$DISCR\_PROD_{i,t}$ Discretionary production costs in year t, per Roychowdhury (2006), calculated as the residual (ε) from the following regression estimated by three-digit SIC code and fiscal year combinations, requiring at least 10 observations for each combination:

$$\frac{PROD_{i,t}}{TA_{i,t-1}} = \varphi_0 + \varphi_1 \frac{1}{TA_{1,t-1}} + \varphi_2 \frac{SALE_{i,t}}{TA_{i,t-1}} + \varphi_3 \frac{\Delta SALE_{i,t}}{TA_{i,t-1}} + \varphi_4 \frac{\Delta SALE_{i,t-1}}{TA_{i,t-1}} + \varepsilon_{i,t}$$

where *PROD* is cost of goods sold (COGS) plus change in inventory (INV); *TA* is total assets (AT); *SALE* is sales (SALE); Δ*SALE* is change in sales.

APPENDIX B

Parallel Trends for Difference-in-Differences Design

	Conforming TA	Nonconforming TA			Total TA
Variables	$Conform\_Tax_{it}$	ETR_{it}	$CETR_{it}$	$PBTD_{it}$	TTA_{it}
$TAXCLFIRM_i$	0.001*	-0.017***	0.004	0.003**	0.001
	(0.066)	(0.000)	(0.523)	(0.032)	(0.308)
$POST_{it}$	0.002**	0.005	0.018***	-0.003*	0.002***
	(0.033)	(0.328)	(0.001)	(0.065)	(0.008)
$TAXCLFIRM_i \times POST_{it}$	-0.002**	0.013**	-0.011	-0.004*	-0.001
	(0.038)	(0.036)	(0.129)	(0.069)	(0.203)
PRE_{t-1}	-0.000	0.005	-0.003	-0.000	-0.001
	(0.789)	(0.525)	(0.699)	(0.888)	(0.507)
$TAXCLFIRM_i \times PRE_{t-1}$	-0.000	-0.008	-0.022*	0.001	-0.002
	(0.886)	(0.502)	(0.098)	(0.743)	(0.458)
PRE_{t-2}	-0.002	-0.013*	-0.013	0.002	-0.003**
	(0.162)	(0.091)	(0.142)	(0.522)	(0.045)
$TAXCLFIRM_i \times PRE_{t-2}$	0.001	0.005	0.001	0.001	0.001
	(0.762)	(0.653)	(0.967)	(0.758)	(0.724)
BTD_{it}	-0.144***				
	(0.000)				
NEG_{it}	0.001				
	(0.176)				
$BTD_{it} \times NEG_{it}$	0.053***				
	(0.001)				
Intercept	-0.019***	0.462***	0.340***	-0.097***	0.016**
	(0.003)	(0.000)	(0.000)	(0.000)	(0.024)
Control Variables	Included	Included	Included	Included	Included
Year Fixed Effects	YES	YES	YES	YES	YES
Industry Fixed Effects	YES	YES	YES	YES	YES
R^2	0.621	0.220	0.222	0.340	0.673
N	5,926	5,926	5,926	5,666	5,926

*, **, *** indicate statistical significance at the 10%, 5%, and 1% levels, respectively, using a two-tailed t-test. This table presents the difference-in-differences regression results estimated from testing Equation (3) with two additional interaction terms *TAXCLFIRM* × PRE_{t-1} and *TAXCLFIRM* × PRE_{t-2}, where PRE_{t-1} equals 1 for year t-1 prior to the resolution of a comment letter and PRE_{t-2} equals 1 for year t-2 prior to the resolution of a comment letter. Those difference-in-differences estimators, *TAXCLFIRM* × PRE_{t-1}, *TAXCLFIRM* × PRE_{t-2} and *TAXCLFIRM* × *POST*, demonstrate the trend for the years prior to and the years following the resolution of a tax-related comment letter.

APPENDIX C

Falsification Tests: Difference-in-Differences Analysis on Pre-Event Years

	(1)	(2)	(3)
Variables	$Conform\_Tax_{it}$	$Conform\_Tax_{it}$	$Conform\_Tax_{it}$
$TAXCLFIRM_i$	0.001*	0.001*	0.001
	(0.070)	(0.082)	(0.180)
$PSEUDO\_POST1_{it}$	0.001		
	(0.453)		
$PSEUDO\_POST2_{it}$		0.000	
		(0.801)	
$PSEUDO\_POST3_{it}$			-0.001
			(0.297)
$TAXCLFIRM_i \times PSEUDO\_POST1_{it}$	-0.001		
	(0.113)		
$TAXCLFIRM_i \times PSEUDO\_POST2_{it}$		-0.001	
		(0.160)	
$TAXCLFIRM_i \times PSEUDO\_POST3_{it}$			-0.001
			(0.346)
BTD_{it}	-0.145***	-0.145***	-0.145***
	(0.000)	(0.000)	(0.000)
NEG_{it}	0.001	0.001	0.001
	(0.187)	(0.182)	(0.170)
$BTD_{it} \times NEG_{it}$	0.054***	0.053***	0.053***
	(0.000)	(0.001)	(0.001)
Intercept	-0.019***	-0.019***	-0.018***
	(0.003)	(0.003)	(0.003)
Control Variables	Included	Included	Included
Year Fixed Effects	YES	YES	YES
Industry Fixed Effects	YES	YES	YES
R^2	0.621	0.621	0.621
N	5,926	5,926	5,926

*, **, *** indicate statistical significance at the 10%, 5%, and 1% levels, respectively, using a two-tailed t-test. This table presents the results for re-estimating Equation (3) when *Conform_Tax* is the dependent variable and replacing actual event years (i.e. years of resolution of tax-related comment letters) with pseudo-events that are deemed to occur one (or two or three) year(s) before the actual resolution of tax related comment letters. The statistically insignificant coefficients on the interaction between *TAXCLFIRM* and *PSEUDO_POST1* (or *PSEUDO_POST2* or *PSEUDO_POST3*) suggest that the observed change in *Conform_Tax* is more likely due to tax-related comment letters as opposed to some unknown alternative force happened in the past.